

## **Fiscal Adjustment for Sustainable Growth in the Dominican Republic**

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### **Abstract**

In preparing this paper we have examined all the major tax systems in the Dominican Republic except the property tax. Our focus was both on the short term revenue requirements of the government as well as on the tax reform measures that are needed in order to meet the longer term revenue requirements of the public sector in an environment where tariff and institutional barriers to international trade are being reduced.

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# Fiscal Adjustment for Sustainable Growth in the Dominican Republic

## Summary

In preparing this report we have examined all the major tax system in the Dominican Republic, except the property tax. Our focus was both on the short term revenue requirements of the government as well as on the tax reform measures that are needed in order to meet the longer term revenue requirements of the public sector in an environment where tariff and institutional barriers to international trade are being reduced. The issues covered and the conclusions are as follows:

### I. Tax and Customs Administration

- To be competitive, an efficient public administration is a necessary condition. Tax and Customs administration, the system of the Justice and the regulation of financial institutions are the four most important components of public administration for the development of a competitive world-class economy.
- The procedures and organization currently embodied in the tax code no longer provide a suitable legal foundation for a modern tax administration.
- There are a number of current weaknesses in the tax administration that are hindering the government from implementing tax policies that will be badly needed. The effectiveness of Customs administration has deteriorated over the past few years.
- **For example, the revenue loss of ITBIS alone due to its deterioration in 2002 was RD\$ 1.69 billion (0.43% of GDP).**
- Both the Customs and the Tax Administration need to modernize further and implement best practice administrative methods.

### **Recommendations:**

1. **Urgent need to have a thorough revision of the sections of the current tax code dealing with tax administration in order to make it consistent with modern practices of tax administration.**
2. **Combine the Customs and Tax Administrations and form a semi-autonomous revenue authority. Given the need for a rapid improvement in the quality of service in these areas, it is likely that such administrative reforms would only be possible if they were implemented by such an institution.**

## **II. Individual Income Tax**

- Relatively few changes are needed in the technical structure of this tax.

### **Recommendations:**

3. To get independent professionals (doctors, lawyers, accountants, engineers) into the tax net, it is recommended that they be subject to a single rate of withholding tax of either 10% or 15%. This tax could be collected as a final tax, or the individuals could be given the option of filing individual income tax returns and taking the single rate withholding tax as a credit against the personal income tax.

**Revenue Impact in 2002 prices: Positive contribution but no quantitative estimate.**

4. If interest expenses are allowed as a deduction in the calculation of business taxable income then the interest paid by financial institutions to individuals should be subject to taxation. It is recommended that either a withholding tax be levied on interest income paid by financial institutions at a rate of either 5% or 10%.

**Revenue Impact in 2002 prices:**

**If rate 5% - gain of RD\$0.75 billion (0.19% of GDP);**

**If rate 10% - gain of RD\$1.53 billion (0.39% of GDP).**

## **III. Corporation Income Tax**

- Relatively few changes needed in the technical structure of this tax.
- The 1.5 % gross receipts withholding tax has been very effective. It has reduced the burden of the corporation income tax on corporate profits as the 1.5% gross receipts tax is a broad based turnover tax that will be largely passed on to consumers.

### **Recommendations:**

5. The same rate of 1.5% should be applied to all businesses, small as well as large. To minimize the administrative hassle of the Tax Administration and to lower the evasion incentives for the private sector, it is suggested to abolish the different rates of gross receipts withholding tax on small businesses and replace it with a single flat 1.5% rate.

**Revenue Impact in 2002 prices: gain of RD\$1.27 million.**

6. The over adjustment for the impact of inflation present in the current law should be corrected. This can be done by bringing into taxable income an amount equal to the rate of inflation time the amount of net debt held by the company.

**Revenue Impact in 2002 prices: gain of RD\$1.20 billion (0.31% of GDP).**

#### **IV. Tax on the Transfer of Industrial Goods and Services (ITBIS)**

- While the basic legal structure is quite good, it suffers from having too many exemptions, and the administration of the tax could be significantly improved.

##### **Recommendations:**

7. We recommend the exempt list only include:
  - live animals;
  - basic groceries including meat, fish, milk, butter, cheese;
  - rice, potatoes, bread, cereals, wheat, corn, beans, fruits, vegetable;
  - gas and diesel oil;
  - a list of essential drugs prescribed by medical doctors;
  - electricity;
  - deposit-taking and other financial services other than insurance for technical reason that virtually no country in the world has taxed this sector; and
  - some social services for not commercial purpose such as education, health services etc. because of the difficulty in measuring the price of output. The exceptions are services provided by private schools and private clinics for the purpose of profit making.

**Revenue Impact in 2002 prices: gain of RD\$2.24 billion (0.57% of GDP).**

#### **V. Special Consumption Taxes - Excise Taxes**

- The excise tax system is in need of a major reform. Excise taxes will play a more important role in the future with the implementation of the tax reforms that reduce the role of tariffs in the revenue system.
- At the present time because the excise taxes are applied to more imported goods than are applied to domestic produced items, there is an element of trade protection in the excise tax system.
- The present progressive rate structure with rates going from 0% to 80% on cars is not working as designed. The average effective rate of excise tax ends up at only 1.58 %, generating revenue of only RD\$210 million in 2002. The progressive rate structure serves primary as a catalyst for corruption and tax evasion.
- The progressive excise rate structure brings about a serious under-valuation of vehicles for purposes of tariff, excise and ITBIS.

##### **Recommendations:**

8. Abolish the existing progressive excise tax rate for passenger vehicles, and initially impose a 20 percent excise tax rate on these vehicles on top of a general 10 percent import duty rate. Further changes would be required as part of the broader tax reform.

**Revenue Impact in 2002 prices: gain of RD\$550 million (0.14% of GDP) on excise taxes alone.**

9. Adjust upward the excise rates on domestically produced goods in line with the proposed excise rates on imported goods (see Recommendation 14).  
**Revenue Impact in 2002 prices: gain of RD\$1.00 billion (0.25% of GDP).**
10. An excise tax of 10 percent should be levied on all telecommunication services in addition to the 2 percent, which is currently paid to the industry regulating body. Keep the existing 12 percent ITBIS rate.  
**Revenue Impact in 2002 prices: gain of RD\$1.91 billion (0.48% of GDP).**
11. In the case of airline tickets, we recommend to levy a 10 percent excise tax on the sale of airline tickets and exempt them from the ITBIS.  
**Revenue Impact in 2002 prices: an incremental gain.**
12. Impose a 10 percent excise tax on insurance premiums and exempt them from the ITBIS.  
**Revenue Impact in 2002 prices: gain of at least RD\$250 million (0.064% of GDP).**

## **VI. Taxation of International Trade Transactions**

- Over 16 percent of the total revenues are currently obtained from tariffs on imports. All other parts of the tax system will need to be changed and strengthened to fill the revenue gap created by lowering and eventually eliminating tariffs.
- At the present time there are three main types of imports: (1) Those for use in the free trade zones (exempted from duties) – RD\$29.6 billion; (2) Imports exempted by trade agreements - RD\$1.03 billion; and (3) All other imports - RD\$106.39 billion.
- The total CIF volume of all imports was RD\$137.03 billion in 2002, and the official classification of imports divides that volume into 15 trade regimes.
- Regime 1 is the most important as it accounts for more than three-quarters of the total imports. The free zones (Regimes 10 and 11) account for 21.5 percent of the total volume of imports in 2002.
- In 2002, non-excisable goods accounted for 91.1 percent of the total imported goods. At present, there are 8 tax rates imposed on all imported goods. These rates are 0, 3, 8, 14, 15, 20, 25, and 40 percent.
- Currently the excise taxes vary from 10 to 60 percent on 48 different classes of commodities. Excisable commodities are subject to 14 or 20 percent import duty rates as well as a commission charged on foreign exchange of 10 percent.
- The total actual collection of import duties was RD\$11.21 billion in 2002, of which only RD\$48 million was collected from the Caribbean countries and other countries with whom the Dominican Republic had trade agreements.

- A substantial amount of revenue is collected from the commission charged on foreign exchange transactions. In 2002 this amounted to RD\$4.73 billion, when the rate was 4.75 percent. In October 2003 the rate was increased to 10 percent.
- There are quotas imposed on certain imported goods: garlic, rice, sugar, poultry, onions, beans, powdered milk, and corn.
- A small amount of export duties, RD\$2 million, is collected per year. In October 2003, the government also imposed recently 5 percent on exported goods including those from free zones. The collection of this tax has not been effective to date.
- There are also 20 resolutions that provide import duty exemptions to various institutions. The resolutions are scattered across the 15 regimes.

### **Recommendations:**

13. Remove the export duties.  
**Revenue Impact in 2002 prices: loss of RD\$2 million.**
14. For imported excisable goods, except vehicles, replace their tariff rates by a flat 10 percent duty, and raise the excise rate for each commodity so that the consumer price, inclusive of ITBIS, remains constant. The rise in the excise rate compensates for the loss of tariff revenue and loss of commission on foreign exchange.  
**Revenue Impact in 2002 prices: revenue neutral for all imported excisable goods, except vehicles (for vehicles, see Recommendation 8).**
17. Remove resolutions made for government departments (Resolutions 1 and 11), NGOs (Resolution 2), education (Resolution 10), government employees (Resolution 6), promotion for hotel tourism (Resolution 5), agriculture (Resolution 8), textile manufacturing (Resolution 9) and the office of Director of Communication (Resolution 12).  
**Revenue Impact in 2002 prices: gain of RD\$0.98 billion (0.25% of GDP).**
18. For imported non-excisable, non-exempt goods, initiate a gradual reduction of tariff rates. A four phased plan is proposed. In Phase I, remove the 4.75% foreign exchange commission and simplify import tariff structure for non-excisable goods to 4 rates (5, 10, 15 and 20%).  
**Revenue Impact in 2002 prices: loss of RD\$1.97 billion (0.50% of GDP).**
19. In Phase II, reduce the top tariff rate of 20% to 15%, and have only to 3 rates (5, 10, and 15%).  
**Revenue Impact in 2002 prices: additional loss of RD\$0.91 billion (0.23% of GDP).**
20. In Phase III, eliminate all tariffs on non-excisable goods, have a single 0% rate. For excisable commodities, raise the excise rates to recoup the revenue loss from their tariff reduction.  
**Revenue Impact in 2002 prices: additional loss of RD\$7.21 billion (1.83% of GDP), inclusive of behavioral responses. Revenue neutral for excisable goods.**

21. In Phase IV, give up an additional 5.25% foreign exchange commission; and remove certain goods from the excise list.  
**Revenue Impact in 2002 prices: additional loss of RD\$5.51 billion (1.40% of GDP).**
22. To finance the **total revenue loss** after Phase III (RD\$0.49 billion or 0.12% of GDP) and after Phase IV (RD\$5.51 billion or 1.40% of GDP), the government will need to raise the ITBIS rate while strengthening the ITBIS administration. See summary table of proposed measures below for the net cumulative revenue estimation.  
**Revenue Impact in 2002 prices:**  
**To Finance Phase III: raise ITBIS rate by 1%,**  
**To Finance Phase III plus Phase IV: raise ITBIS rate by 4%.**

## **VII. Complying with WTO Restrictions on the Use of Free Trade Zones by 2008**

- In 2002 there were 520 operating companies in the free trade zones, providing employment for over 170,000 workers and generating a net of exports over imports of approximately US\$1.7 billion. Textiles have made up over 50 percent of the exports and 70 percent of the employment of the zones, with the textile sales going mainly to the United States.
- One of the principal reasons why the free trade zones have developed in this way was to insulate these activities from the historically weak and user unfriendly administration systems for taxation and customs.
- For companies operating in the zone, there are no taxes of any kind, except individual income taxes. Payments are made directly to the zone operators for the services received.
- For a small open economy producing traded manufactured goods, the tax policies that have been given to the zones are the correct ones: no subsidies; no indirect domestic or trade taxes; and no corporation income tax on income earned in the free trade zones.
- If the WTO principles are imposed on the free zones then the burden of the increase in corporation income taxes on the income from capital used to manufacture traded goods will be borne more than 100 percent by labor.

### **Recommendations:**

23. If the country decides to impose the corporation income tax on companies operating in the free trade zones, then the following measures should be taking to ease the tax burden on foreign investors operating in the zones:
- Exempt the zones from 1.5% gross sales withholding tax;
  - Do not administratively pursue companies in the zones who practice transfer-pricing;
  - Facilitate an efficient system for the refund of excess ITBIS tax credits for tax paid on inputs used to produce exports;
  - Set up a system of duty suspension for duties on imported inputs for exporters operating either in the zones or outside the zones.

## **VIII. Conclusion**

The financial crisis of 2003 and the approaching date of trade liberalization with the Americas have sharpened the need for a major overhaul of the existing tax system and policies in the Dominican Republic. The desired properties of a reformed system are revenue sufficiency, buoyancy, fairness, and administrative simplicity, with an orientation toward the promotion of sustainable economic growth.

We believe these objectives are possible to achieve over a fairly short period. We have examined most areas of tax policy and tax administration in order to develop a comprehensive set of reform proposals. The final result of this reform should be an economy open to international trade, with a balanced tax system that would rely more heavily than today on the ITBIS and selective taxes on consumption for revenue.

A central feature of this reform is the recommendation for the modernization of the tax and customs administration. A determined effort is needed to revive and modernize their functions in order to attain the level of efficiency that the Dominican Republic needs in order to be an internationally competitive economy.

## Summary of Tax Proposals and Revenue Implications

Major Tax Systems	Revenue Raising Measures	Impact on Annual Revenue in 2002 Prices, RD\$ billions	Impact on Annual Revenue in % of GDP
Individual Income Tax	<ul style="list-style-type: none"> <li>▪ Impose a 15% tax rate on gross earnings of professionals</li> <li>▪ Raise the tax rates of 0.75 to 1.25% on receipts for small businesses to 1.5%</li> <li>▪ Impose a rate of 10% on interest earned by individuals from deposit-taking institutions</li> <li>▪ Strengthen tax administration</li> </ul>	<ul style="list-style-type: none"> <li>▪ Positive effect</li> <li>▪ Raise RD\$1.27 million</li> <li>▪ Raise RD\$1.53 billion</li> <li>▪ Positive effect</li> </ul>	<ul style="list-style-type: none"> <li>▪ Positive effect</li> <li>▪ Raise 0.0003% of GDP</li> <li>▪ Raise 0.39% of GDP</li> <li>▪ Positive effect</li> </ul>
Corporate Income Tax	<ul style="list-style-type: none"> <li>▪ Adjust income up by the rate of inflation times the amount of net financial debt held by corporation while allowing for the full deduction of interest expenses and depreciation of assets with inflation adjustment</li> </ul>	<ul style="list-style-type: none"> <li>▪ Raise RD\$1.20 billion</li> </ul>	<ul style="list-style-type: none"> <li>▪ Raise 0.31% of GDP</li> </ul>
ITBIS (VAT)	<ul style="list-style-type: none"> <li>▪ Expand tax base</li> <li>▪ Keep the exempt list to basic grocery, petroleum products, essential medical drugs, electricity, deposit-taking and other financial services, and some social services</li> <li>▪ Provide immediate refunds of excess input tax credits especially for export-oriented firms</li> <li>▪ Strengthen Customs and the tax administration</li> </ul>	<ul style="list-style-type: none"> <li>▪ Raise RD\$2.24 billion</li> </ul>	<ul style="list-style-type: none"> <li>▪ Raise 0.57% of GDP</li> </ul>
Tariff Reform on Imported Excisable Goods	<ul style="list-style-type: none"> <li>▪ Lower all import tariffs on excisable goods to 10% and adjust excise tax rates on each of the excisable goods with the exception of vehicles in order to keep retail prices unchanged</li> <li>▪ For vehicles, impose a flat excise tax rate of 20% on top of the general 10% import duty</li> </ul>	<ul style="list-style-type: none"> <li>▪ Revenue-neutral for excisable goods other than vehicles</li> <li>▪ Raise RD\$0.55 billion for vehicles</li> </ul>	<ul style="list-style-type: none"> <li>▪ Revenue-neutral for excisable goods other than vehicles</li> <li>▪ Raise 0.14% of GDP for vehicles</li> </ul>
Reform of Domestically Produced Excisable Goods	<ul style="list-style-type: none"> <li>▪ Adjust excise tax rates as the same as the above proposed rates for imported goods</li> <li>▪ Impose a 10% on the telecommunication service</li> <li>▪ Levy a 10% on airline tickets and insurance premiums, but exempting both under the ITBIS</li> </ul>	<ul style="list-style-type: none"> <li>▪ Raise RD\$1.00 billion</li> <li>▪ Raise RD\$1.91 billion for phone services</li> <li>▪ Raise RD\$0.25 billion for airline tickets and insurance services</li> </ul>	<ul style="list-style-type: none"> <li>▪ Raise 0.25% of GDP</li> <li>▪ Raise 0.48% of GDP for phone services</li> <li>▪ Raise 0.064% of GDP for airline tickets and insurance services</li> </ul>
Reform Resolutions	<ul style="list-style-type: none"> <li>▪ Remove import duty exemptions for Resolutions 1,2,5,6,8,9,10,11 and 12</li> </ul>	<ul style="list-style-type: none"> <li>▪ Raise RD\$0.93 billion</li> </ul>	<ul style="list-style-type: none"> <li>▪ Raise 0.24% of GDP</li> </ul>
Tax and Customs Administration	<ul style="list-style-type: none"> <li>▪ Establish a semi-autonomous revenue authority</li> <li>▪ Modernize tax administration</li> <li>▪ Improve and modernize the Customs Administration</li> <li>▪ Refund excess input tax credits under ITBIS</li> <li>▪ Make tax exempt system work for export-oriented firms</li> </ul>	<ul style="list-style-type: none"> <li>▪ Minimize leakage</li> <li>▪ Protect tax revenues</li> <li>▪ Provide taxpayer services</li> </ul>	<ul style="list-style-type: none"> <li>▪ Positive Effect</li> </ul>
<b>Subtotal Revenue Raising Measures before Increasing ITBIS Rate</b>		<ul style="list-style-type: none"> <li>▪ <b>Raise RD\$9.60 billion</b></li> </ul>	<ul style="list-style-type: none"> <li>▪ <b>Raise 2.44% of GDP</b></li> </ul>
<ul style="list-style-type: none"> <li>▪ <b>Raising ITBIS rate by 4.0 percentage to 16 percent rate with a broadened tax base</b></li> </ul>		<ul style="list-style-type: none"> <li>▪ Raise RD\$6.00 billion</li> </ul>	<ul style="list-style-type: none"> <li>▪ Raise 1.53% of GDP</li> </ul>
<b>Total Revenue Raising Measures</b>		<ul style="list-style-type: none"> <li>▪ <b>Raise RD\$15.59 billion</b></li> </ul>	<ul style="list-style-type: none"> <li>▪ <b>Raise 3.97% of GDP</b></li> </ul>

**Summary of Tax Proposals and Revenue Implications  
(Continued)**

<b>Phases of Tax Reform</b>	<b>Measures Reducing Revenue Collection Import Tariff Reform on Non-Excisable Goods</b>	<b>Impact on Annual Revenue in 2002 Prices, RD\$ billions</b>	<b>Impact on Annual Revenue in % of GDP</b>
Phase I	<ul style="list-style-type: none"> <li>▪ Remove 4.75% foreign exchange commission</li> <li>▪ Simplify import tariff structure for non-excisable goods to 4 rates (5, 10, 15 and 20%)</li> </ul>	▪ Loss of RD\$1.97 billion	▪ Loss of 0.50% of GDP
Phase II	<ul style="list-style-type: none"> <li>▪ Reduce the upper tariff rate to 15% from 20%, and have only 3 rates (5, 10, and 15%)</li> </ul>	▪ Loss of RD\$0.91 billion	▪ Loss of 0.23% of GDP
Phase III	<ul style="list-style-type: none"> <li>▪ Remove all tariffs on non-excisable goods, have a single 0% rate</li> </ul>	▪ Loss of RD\$7.21 billion	▪ Loss of 1.83% of GDP
Phase IV	<ul style="list-style-type: none"> <li>▪ Remove the additional 5.25% foreign exchange commission</li> <li>▪ Reduce the list of excisable goods.</li> </ul>	▪ Loss of RD\$5.51 billion	▪ Loss of 1.40% of GDP
<b>Subtotal Revenue Reducing Measures</b>		▪ <b>Loss of RD\$15.59 billion</b>	▪ <b>Loss of 3.97% of GDP</b>

# Fiscal Adjustment for Sustainable Growth in the Dominican Republic

## 1. Introduction

During the period from 1994 to 2001, the Dominican Republic lowered its budgetary deficit from a high 3.7 percent to 1.8 percent of GNP. As a result, the stock of public debt also declined to a level of about 23.8 percent of GDP. The fiscal situation appeared to be improving, however, in 2003 the failure of Baniter bank and two other private banks caused large Central Bank deficits. By the end of 2003, the result was a large devaluation, an inflation rate of 40 percent, and an increase in the stock of public debt to 48.0 percent of GDP by the end of 2003. The real GDP growth rate in 2003 was a negative 2.5 percent. The government has since taken steps and actions to strengthen the banking system to gain people's confidence. More economic measures are also being considered in order to maintain macroeconomic stability.

Other than the episodes in the financial sector, the government has also been under pressure in its fiscal sustainability policies because of its commitment to reform the social security system, to enhance infrastructure investment, and to alleviate poverty through improved health care. On the tax revenue side, the Government is under pressure from the policies of other countries in the region, including the free trade negotiations with the United States, to further reduce the rates of import tariff and others trade distortions.<sup>1</sup>

This report will describe the current tax structure, analyze its strengths and weaknesses, and make a number of proposals for its improvement. In addition to identifying a series of short-run revenue enhancements, a major objective of this report is to develop a plan for a tax reform that will enable the Dominican Republic to move away permanently from using taxes on international trade as a significant source of revenues. This shift is necessitated by the desire of the Dominican Republic to enter into a free trade agreement with the US and the countries of Central America. In carrying out this study each part of the tax system under consideration has been empirically modeled in order to develop revenue estimates of the proposed tax changes.

## 2. Overview of Existing Tax System

Details of the major categories of public sector revenues and non-tax revenues are presented in absolute amounts and percentages of GDP in Tables 1 and 2, respectively. From Table 2, we find that the Government of the Dominican Republic has raised the level of its tax and non-tax revenues from about 15.6 percent of GDP in 1999 to 16.8 percent in 2002.

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<sup>1</sup> See Oscar Melhado, "Fiscal Sustainability and Resource Mobilization in the Dominican Republic", International Monetary Fund Working Paper, January 2003, The Economic Commission for Latin America and the Caribbean (ECLAC) Subregional Headquarters for the Caribbean, "The Fiscal Implications and Macroeconomic Effects of Trade Liberalization – The Dominican Republic", a confidential report, January 2003.

At present, the main sources of tax revenues are the income tax, the tax on the transfer of individual goods and services (ITBIS), excise taxes on goods and services including petroleum products, and import duties. These taxes account for more than 88.2 percent of the total tax and non-tax revenues collected in 2002, compared to 83.2 percent in 2000 and 87.2 percent in 2001.

In recent years the Dominican Republic has implemented a number of tax policy measures. In particular, since 2001 a minimum withholding tax was levied on all corporations equivalent to 1.5 percent of gross revenues. This tax is credited against the corporation income tax liability. Individual income tax brackets were adjusted and the top rate was lowered from 30 percent to 25 percent. The ITBIS, a tax similar to a consumption type value added tax, was raised from a flat rate of 8 percent to 12 percent. A short list of certain services such as advertisement and publishing was granted a reduced ITBIS rate of 6 percent. The rates of import duty were lowered and an attempt was made to implement the GATT rules for commodity valuation. The combination of these two policies has substantially lowered import duty revenues.<sup>2</sup> Despite its trade liberalization efforts, the Dominican Republic has increased its overall tax revenues by almost 0.65 percent of GDP in 2001 and a further 0.25 percent in 2002.

On July 1, 2003, all imported goods were made subject to an additional 2 percent rate of import duty. In late October 2003, the Government had to resort to further temporary measures in order to stabilize the foreign exchange market and macroeconomic environment. These measures include an increase in the commission charged on foreign exchange transactions from 4.75 percent to 10 percent, and the airport departure tax was increased from US\$10 to US\$20.

In the report that follows, we make a number of suggestions that would strengthen the tax system and make it more buoyant in terms of revenue collection while reducing some of the economic distortions that exist now. A phased plan is also set out for a major reform of the import tariff system. The consequential changes in other taxes that this reform necessitates in order to stabilize the overall government revenues are also shown in detail. As a result, the ratio of the total tax and non-tax revenues to GDP should at least remain steady or to be raised slightly in future years in order to have adequate resources to fund various government programs. Having established a sound and stable tax system is one of the most important elements for sustainable growth in the Dominican Republic.

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<sup>2</sup> The import duty collections as a percentage of GDP declined from 4.32 percent in 2000 to 2.68 percent in 2001.

**Table 1**  
**Tax and Non-Tax Revenues by Main Categories**  
(millions of nominal RD pesos)

	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003 Q 1,2</u>
<b>I. Total revenue and grants</b>	<b>38,949</b>	<b>43,908</b>	<b>51,692</b>	<b>60,271</b>	<b>67,009</b>	<b>36,770</b>
<b>II. Total revenue</b>	<b>38,566</b>	<b>43,484</b>	<b>51,271</b>	<b>59,856</b>	<b>67,009</b>	<b>36,211</b>
<b>III. Tax and non-tax revenue</b>	<b>38,390</b>	<b>43,375</b>	<b>51,151</b>	<b>59,642</b>	<b>66,227</b>	<b>36,172</b>
<b>IV. Tax revenue</b>	<b>36,260</b>	<b>40,899</b>	<b>47,565</b>	<b>56,996</b>	<b>63,294</b>	<b>33,689</b>
Taxes on income	7,735	9,510	11,126	15,839	16,729	10,128
Taxes on property	596	793	926	970	930	561
Taxes on goods and services	17,410	16,862	17,609	26,558	30,465	15,874
ITBIS (VAT)	7,178	8,563	9,912	14,225	16,579	8,917
Domestic	3,697	4,483	5,309	8,484	9,681	5,821
External	3,481	4,080	4,602	5,741	6,898	3,096
Excises	10,232	8,299	7,697	12,332	13,886	6,957
Excises on goods	8,603	6,721	6,047	11,401	12,853	6,952
Tobacco	382	404	469	996	1,069	553
Beverages	1,953	2,146	2,451	2,886	3,220	1,760
Petroleum Products	6,260	4,162	3,124	7,511	8,101	3,889
Others	8	9	3	7	462	750
Excises on services	1,629	1,578	1,650	932	1,033	6
Communications	238	86	7	2	0	0
Transports	863	857	851	580	0	0
Other services	528	636	793	350	1,032	6
Taxes on international trade	10,364	13,293	17,211	12,856	14,203	7,067
Import duties	10,362	12,589	13,847	9,620	11,211	5,590
Export duties	2	2	3	2	2	2
Foreign exchange commission	0	702	3,360	3,234	2,989*	1,475
Other taxes	155	441	694	773	967	59
<b>V. Non-Tax revenue</b>	<b>2,129</b>	<b>2,476</b>	<b>3,586</b>	<b>2,646</b>	<b>2,933</b>	<b>2,482</b>
Property income	635	589	1,202	667	493	0
Administrative fees and charges	1,203	1,427	1,846	1,638	2,424	0
Other non-tax revenue	292	460	539	340	15	2,482
<b>VI. Capital revenue</b>	<b>176</b>	<b>109</b>	<b>120</b>	<b>214</b>	<b>783</b>	<b>39</b>
<b>VII. Grants</b>	<b>383</b>	<b>424</b>	<b>421</b>	<b>416</b>	<b>0</b>	<b>559</b>
<b>GDP</b>	<b>241,977</b>	<b>277,747</b>	<b>320,880</b>	<b>359,426</b>	<b>393,315</b>	<b>----</b>

Sources: Central Bank of the Dominican Republic, October, 2003.

Note: \* This figure is related to 3 percent commission on foreign exchange. The other 1.75 percent commission on foreign exchange -- approximately RD\$1,744 million pesos -- is not recorded here as it is earmarked for external debt services.

**Table 2**  
**Tax and Non-Tax Revenues by Main Categories**  
**(percentage of GDP)**

	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>
<b>I. Total revenue and grants</b>	<b>16.10</b>	<b>15.81</b>	<b>16.11</b>	<b>16.77</b>	<b>17.04</b>
<b>II. Total revenue</b>	<b>15.94</b>	<b>15.66</b>	<b>15.98</b>	<b>16.65</b>	<b>17.04</b>
<b>III. Tax and non-tax revenue</b>	<b>15.87</b>	<b>15.62</b>	<b>15.94</b>	<b>16.59</b>	<b>16.84</b>
<b>IV. Tax revenue</b>	<b>14.99</b>	<b>14.73</b>	<b>14.82</b>	<b>15.86</b>	<b>16.09</b>
Taxes on income	3.20	3.42	3.47	4.41	4.25
Taxes on property	0.25	0.29	0.29	0.27	0.24
Taxes on goods and services					
ITBIS (VAT)	2.97	3.08	3.09	3.96	4.22
Domestic	1.53	1.61	1.65	2.36	2.46
External	1.44	1.47	1.43	1.60	1.75
Excises					
Excises on goods	3.56	2.42	1.88	3.17	3.27
Tobacco	0.16	0.15	0.15	0.28	0.27
Beverages	0.81	0.77	0.76	0.80	0.82
Petroleum Products	2.59	1.50	0.97	2.09	2.06
Others	0.00	0.00	0.00	0.00	0.12
Excises on services	0.67	0.57	0.51	0.26	0.26
Communications	0.10	0.03	0.00	0.00	0.00
Transports	0.36	0.31	0.27	0.16	0.00
Other services	0.22	0.23	0.25	0.10	0.26
Taxes on international trade					
Import duties	4.28	4.53	4.32	2.68	2.85
Export duties	0.00	0.00	0.00	0.00	0.00
Foreign exchange commission	0.00	0.25	1.05	0.90	0.76
Other taxes	0.06	0.16	0.22	0.21	0.25
<b>V. Non-Tax revenue</b>	<b>0.88</b>	<b>0.89</b>	<b>1.12</b>	<b>0.74</b>	<b>0.75</b>
Property income	0.26	0.21	0.37	0.19	0.13
Administrative fees and charges	0.50	0.51	0.58	0.46	0.62
Other non-tax revenue	0.12	0.17	0.17	0.09	0.00
<b>VI. Capital revenue</b>	<b>0.07</b>	<b>0.04</b>	<b>0.04</b>	<b>0.06</b>	<b>0.20</b>
<b>VII. Grants</b>	<b>0.16</b>	<b>0.15</b>	<b>0.13</b>	<b>0.12</b>	<b>0.00</b>

Sources: Calculated from Table 1.

### **3. Domestic Tax on Income**

As shown in Table 3, more than a half of the total income tax revenues are collected from individuals. The remainder is collected from corporations. Each of these taxes will be examined in turn.

#### **3.1 Individual Income Tax**

The individual income tax is levied on income sourced from within the country and incomes arising from investments and financial gains from outside of the country. Taxes are levied on an individual basis so long as income is greater than the basic exemption. There are three tax rates, 15 percent, 20 percent and 25 percent.<sup>3</sup> The basic exemption and the income tax brackets are annually adjusted for inflation, using the consumer price index. For example, in year 2001, the annual basic exemption was RD\$120,000. Income from RD\$120,000 to RD\$200,000 was subject to a marginal tax rate of 15 percent, from RD\$200,000 to RD\$300,000 it was 20 percent, and for income above RD\$300,000 the marginal tax rate was 25 percent.<sup>4</sup> It has a theoretically progressive statutory rate structure with marginal tax rates increasing as income rises.

The individual income taxes are mainly collected from wages and salaries. Interest income is not taxed. Taxes are withheld by employers on behalf of workers and no annual tax return filings are generally required. This accounts for more than 95 percent of the total individual income tax revenue.<sup>5</sup> However, some people may wish to file an annual income tax return in order to use any surplus tax credits from taxes paid on dividends against other sources of incomes.<sup>6</sup> As a result, there were only about 2,000 personal income tax filers in 2002. If sole proprietors or independent professionals such as accountants, lawyers, engineers, and medical doctors provide services to non-corporate clients, there is neither a withholding mechanism nor proper record keeping. Their incomes may largely escape the personal income tax simply because the administrative system is now inadequate to enforce compliance.

Fringe benefits such as housing, vehicles, insurance premiums, and domestic employees are taxed by a special fringe benefits tax at a rate of 25 percent at the level of the employer. At the same time, the cost of providing fringe benefits is a tax-deductible expense for the employer.

Dividends are taxed through an advanced corporation tax system at a rate of 25 percent when they are distributed to company's shareholders. The amount of tax withheld can then be used as a credit against both the future corporate income tax liabilities of the firm and the current personal income tax liabilities of the shareholders. Interest income received from financial institutions as well as from savings and loan associations, however, is currently tax exempt

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<sup>3</sup> The top rate was gradually reduced over three years from 30 percent to 25 percent.

<sup>4</sup> After inflation adjustment, in 2002 the basic exemption was RD\$125,256; the three income tax brackets were between RD\$125,256 and RD\$208,760; RD\$208,760 and RD\$313,140; and beyond RD\$313,140; and the respective tax rates were 15 percent, 20 percent and 25 percent.

<sup>5</sup> This figure was about 95.0 percent for 1998, 95.1 percent for 1999, 95.5 percent for 2000, 92.4 percent for 2001, and 96.1 percent for 2002. See Table 3.

<sup>6</sup> Dividends are subject to a 25 percent advanced corporation tax at the time the dividends are paid. This tax can also be used as a tax credit by individual shareholders.

unless they are paid out to non-residents, in which case a 5 percent withholding tax is levied on the amount of interest transferred abroad.

### *Discussion*

At present, wage and salary earners pay taxes on a pay-as-you-earn basis through withholding by their employers. This system seems to work reasonably well. However, concerns have been raised about the evasion of income earned by sole proprietors and independent professionals. From Table 3, one can see a relatively small share (about 3 percent) of the total income taxes is collected from this group. To bring their income tax more in line with the burden imposed on other wage earners, we recommend that a system of advanced payments should be devised for this group. It is also the hope that such a system might encourage these groups to become a part of the formal tax system over time.

As the level of business expenses is difficult to determine with any degree of accuracy for such activities, it is recommended that a lower flat rate of withholding tax be levied on their gross receipts. Using information from professional associations, the tax department believes that an acceptable estimate of gross receipts can be made for several groups of professionals. Under such a system it is recommended that independent professionals should pay 15 percent of their gross earnings each month as an advanced tax. This assumes that these self-employed professionals have business expenses averaging 40 percent of their gross receipts. If politically a rate of 15 percent proves too difficult to impose, then policy makers should consider imposing a tax of at least 10 percent on gross receipts.

**Table 3**  
**Breakdown of Income Tax Revenues by Category<sup>1</sup>**

<b>Category</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>
Amount (RD\$million)					
PIT: Withheld by Employer <sup>2</sup>	3,711.3	4,537.5	5,662.8	6,482.4	8,241.3
PIT: Self-Assessed	195.1	232.0	264.4	530.2	335.2
Corporate Income Tax	2,551.5	3,113.3	3,499.7	7,055.9	6,041.8
<b>Total</b>	<b>6,457.9</b>	<b>7,882.8</b>	<b>9,426.9</b>	<b>14,068.5</b>	<b>14,618.3</b>
Percentage (%)					
PIT: Withheld by Employer	57.47	57.56	60.07	46.08	56.38
PIT: Self-Assessed	3.02	2.94	2.81	3.77	2.29
Corporate Income Tax	39.51	39.49	37.12	50.15	41.33
<b>Total</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>

Sources: Ministry of Finance, October 2003.

Notes: <sup>1</sup> The aggregate amounts presented in this table are not exactly the same as those shown in Table 1.

Nevertheless, these figures provide a good approximation of the relative shares among the three major categories of the aggregate income tax revenues.

<sup>2</sup> PIT stands for personal or individual income tax.

For other sole proprietors such as retailers and other service providers, a tax rate of 1.5 percent on gross sales should be applied with the implicit assumption that their profit margins are on

average much less than for independent professionals<sup>7</sup>. Having the same tax rate of 1.5 percent applied across the board would remove the variation of different rates imposed on different categories of small businesses. At present, a turnover tax at the rate of 0.75 percent withheld monthly from establishments with gross sales up to RD\$2 million, 1.0 percent from businesses with gross sales between RD\$2 and 4 million, and 1.25 percent on enterprises with gross sales between RD\$4 to 6 million. Failure to comply with the tax should be subject to penalties and interest payments. The sole proprietors or independent professionals should be allowed to file their annual income tax returns based on the general rules stipulated in Act, and to take any advanced tax payments as a credit against income taxes owed.

In the Dominican Republic few, if any, tax refunds are issued. The 1.5 percent withholding tax on receipts becomes essentially a turnover tax that is ultimately passed on to consumers through higher prices. If we consider the gross receipts tax as a turnover tax then there is no tax policy reason why a lower rate should be imposed on the same goods and services if they are sold by a sole proprietor rather than by a larger establishment.

As previously mentioned, at present all interest income earned by individuals from financial institutions as well as from savings and loans associations is tax exempt, while interest payments can be deducted as an expense by corporations. On the other hand, the incomes from equity investments are taxed at 25 percent. This is unjust because interest and the return to equity are simply different parts of the return to capital.

It is, therefore, recommended that a flat tax of up to 10 percent be imposed on interest earned from all deposit-taking institutions. These financial institutions often charge or pay fees on loans and deposits. They should be taxed in the same way as interest income and interest payments because they can be interchangeable with interest. This flat tax withheld by the financial institutions should be a final tax on these sources of income. In the meantime, the current 5 percent withholding tax on the amount of interest paid to non-residents abroad should be raised to 10 percent.

### ***Revenue Impact***

Amending and strengthening the individual income tax on sole proprietors and independent professionals would increase the tax revenue to the treasury. Perhaps a more important impact is that it will make these groups more tax compliant and bring them into the tax base.

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<sup>7</sup> Imposing a 1.5 percent turnover tax rate is equivalent to the rate charged on the net income of small business corporations.

**Table 4**  
**Taxable Incomes, Corporate Income Tax Paid and Additional Collection from Small**  
**Businesses, 2002**  
**(Thousands of RD\$ Pesos)**

Sectors	No. of Firms	No. of Firms with Total Taxable Income below RD\$2 million	Total Taxable Income	CIT Tax Paid *	Estimated Additional Tax
Agriculture	16	16	4,718	13.9	13.8
Chemical Products	28	27	16,598	51.2	0.8
Commerce	1,015	1,010	328,011	717.0	648.2
Communication	4	4	884	0.9	0.9
Construction	9	7	9,498	6.1	6.1
Education	17	16	10,396	14.5	14.3
Financial Intermediation, Insurance, and Financial Services	56	54	28,043	83.1	23.0
Food Processing	22	22	8,654	19.6	19.6
Health	22	20	10,912	31.7	0.0
Hotels and Restaurants	92	92	35,980	93.0	90.4
Manufacturing	48	47	20,292	48.3	29.7
Metal Products	9	9	5,177	6.0	6.0
Miscellaneous Non-Metal Products of Mineral Origin	3	3	1,054	2.0	2.0
Miscellaneous Services (Medical, Casino, etc.)	375	373	107,731	282.0	266.3
Non-Metal Products of Mineral Origin	5	5	1,133	2.3	2.3
Petroleum Products	4	4	1,270	1.9	1.8
Production of Tobacco and Beverage	4	4	3,465	1.7	1.7
Services to Enterprises	66	65	43,352	121.7	97.5
Textile and Accessories	22	22	8,064	11.5	11.3
Transportation	13	13	6,383	18.3	18.2
Water and Electricity	4	4	3,537	18.9	18.9
<b>Total</b>	<b>1,834</b>	<b>1,817</b>	<b>655,153</b>	<b>1,545</b>	<b>1,271</b>

Source: Ministry of Finance, November 2003.

Note: \* CIT stands for corporate income tax.

**Table 5**  
**Current and Proposed Withholding Tax Rates for Small Businesses**

Category	Taxable Income (RD\$)	Current Rate	Proposed Rate
1	0 to 2,000,000	0.75%	1.50%
2	2,000,001 to 4,000,000	1.00%	1.50%
3	4,000,001 to 6,000,000	1.25%	1.50%

From Table 4 we find that there were only 1,834 enterprises registered for the small taxpayer regime. Hence, the administrative hassle needed to treat these few taxpayers differently is hardly justified. The additional revenue that would be gained by equalizing the withholding tax to 1.5 percent of receipts is also small at RD\$1.3 million per year in 2002 prices (Table 4). However, to ease the burden of the tax administration, and to improve overall taxpayer compliances, we would recommend harmonizing the withholding rates at 1.5 percent of gross receipts for all categories of businesses, as shown in Table 5.

In 2002, interest income and fees paid by banks and all other deposit taking institutions were approximately RD\$18,128 million and RD\$983 million, respectively. In total, the sum is RD\$19,111 million, paid not only to individuals but also to companies. If a 10 percent withholding tax rate was imposed on interest and fee income received by individuals only, the government would have raised an additional tax revenue by approximately RD\$1.53 billion in 2002 with the assumption that deposits by individuals account for 80 percent of the total deposit savings. This amount is equivalent to 0.39 of one percentage point of GDP. Details of the interest and fees paid by various financial institutions are presented in Table 6.

**Table 6**  
**Interest and Fees Paid by Financial Institutions, 2002**  
**(millions of RD pesos)**

<b>Types of Financial Institutions</b>	<b>Interest Payment</b>	<b>Fee Expenses</b>	<b>Total</b>
Commercial Banks	12,765.1	862.7	13,627.8
Development Banks	543.6	80.9	624.5
Mortgage Banks	43.4	0.3	43.7
Savings and Loans Associations	4,034.6	2.2	4,036.8
Financial Institutions	571.6	35.8	607.4
Loan Houses	32.6	0.8	33.4
Public Institutions	137.4	0.1	137.5
<b>Total</b>	<b>18,128.4</b>	<b>982.8</b>	<b>19,111.2</b>

Sources: Dominican Republic, Central Bank, *Annual Report 2002*.

### **3.2 Corporate Income tax**

Like other countries, in the Dominican Republic, most corporations pay tax on their profits after deducting various business expenses, including depreciation and interest expenses. The statutory rate of corporate income tax is 25 percent. For small firms with gross income less than the annual threshold of RD\$6 million, lower rates are levied as described in the previous section. There are, however, some exceptions. For example, casinos are taxed at 20 percent of their profits, and slot machines are taxed at a rate of 50 percent.

Like in most countries, operating losses in the Dominican Republic can be carried forward for three years, but not carried backward. It seems to be working fine although some concerns are expressed that the three-year period is not long enough.

As previously mentioned, an annual adjustment for inflation is made to the personal income tax brackets and basic exemption each year. The depreciated value of the assets is also adjusted for inflation in order to obtain the correct basis for the purpose of calculation of the annual amount of depreciation expense. Although the income tax regulations now stipulate that the rate of inflation times the amount of net financial debt outstanding by the end of fiscal year should be included as part of taxable income, this part of adjustments for the effect of inflation on corporation taxable income has not been implemented to date.<sup>8</sup> Without this component, the rest of the other adjustments taken together, end up being over generous to the taxpayer. Nevertheless, it is very important for the stability of the tax system to have a complete system for adjustment of corporate taxable income for the effects of inflation, especially during years of high inflation. However, the system has to be in place even when the rate of inflation is low because periods of high inflation rates are difficult to forecast. The 40 percent rate of inflation in 2003 is a good example of such an unanticipated inflationary episode.

In year 2001, a minimum tax of 1.5 percent rate was levied on the gross sales of all corporations. It is paid monthly to the tax administration. If the amount is less than the corporate income tax by the end of fiscal year, the additional corporate income tax liability is paid to the authority. On the other hand, if the 1.5 percent turnover tax is greater than the corporate income tax, it becomes a final minimum tax.

There are approximately 80,000 corporations in the Dominican Republic. It is informative that the largest 700 firms paid more than 86.5 percent of their corporate income tax liabilities through the 1.5 percent turnover tax in 2002. A detailed analysis of the data is presented by sector in Table 7. It is clear that the 1.5 percent turnover tax is a very effective instrument in collecting corporate income taxes in advance.

The sectors that contributed most to the corporation income tax collection in 2002 were banking and insurance, trade, food processing, tobacco and beverages, chemical production, hotels and restaurants sectors. Of the largest 700 companies, the firms in these sectors paid more than three-quarter of the total income taxes collected from all registered businesses in the country. However, the expansion of the non-taxable government certificates in 2003 will significantly lower the tax liabilities of the banks.

Moreover, there are 520 companies located in 53 free zone parks.<sup>9</sup> Their products are oriented towards the external markets, mainly to the United States and Puerto Rico. For the country as a whole, exports from free zones were about US\$4,335.9 million, accounting for more than 83.6 percent of national exports in 2002. More than one half of the companies (50.38 percent) are engaged in the clothing and textile sectors. Next in importance are services (17.31 percent), tobacco and derivatives (5.19 percent), and the electronics sectors (5 percent). The companies operating in the free zone areas are exempt from the corporate income tax and all indirect taxes such as tariffs and ITBIS.

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<sup>8</sup> This has been clarified by the authors' discussion with senior tax officials at the Ministry of Finance.

<sup>9</sup> National Free Zone Council, *Annual Report 2002*.

**Table 7**  
**Corporate Income Tax Revenues from Largest 700 Companies, 2001-2002**  
**(thousands of RD pesos)**

Sector	No. of Firms	2001			2002		
		1.5% Turnover Tax	Additional Income Tax	Total	1.5% Turnover Tax	Additional Income Tax	Total
Agriculture	2	0	16	16	1,026	0	1,026
Cereals	1	0	0	0	4,541	0	4,541
Chemical Products	63	50,401	32,231	82,632	320,907	25,719	346,626
Commerce	150	83,751	28,210	111,961	693,901	20,012	713,913
Communication	13	7,594	4,816	12,410	43,181	941	44,122
Construction	22	4,278	5,333	9,611	52,624	7,905	60,529
Education	4	640	0	640	1,476	493	1,969
Financial Services and Insurance	71	38,546	38,596	77,142	501,126	222,409	723,535
Food Processing	41	42,921	20,127	63,048	256,030	29,425	285,455
Health	8	3,180	62	3,242	9,410	1,441	10,851
Hotels and Restaurants	81	38,000	11,375	49,375	152,398	16,066	168,464
Live Animals	1	0	0	0	1,252	1,409	2,661
Machinery and Electrical Appliances	3	0	302	302	2,907	134	3,041
Manufacturing	43	8,878	3,953	12,831	88,609	6,836	95,445
Metal Products	7	947	90	1,037	61,280	63	61,343
Milling	4	0	526	526	14,156	606	14,762
Mining	1	0	0	0	701	0	701
Miscellaneous Non-Metal Products of Mineral Origin	3	0	0	0	1,887	4	1,891
Miscellaneous Services (Medical, Casino, etc.)	18	2,645	85	2,730	10,118	2,995	13,113
Non-Metal Products of Mineral Origin	18	0	1,802	1,802	30,185	896	31,081
Oil Refinery	14	23,280	5,043	28,323	68,955	3,088	72,043
Petroleum Products	5	66	122	188	487	9	496
Plastics	3	1,751	434	2,185	3,461	544	4,005
Production of Sugar	2	0	30,782	30,782	44,536	0	44,536
Production of Tobacco and Beverage	26	0	11,980	11,980	283,864	74,890	358,754
Products of Rubber and Plastics	15	388	2,479	2,867	34,391	418	34,809
Services to Enterprises	17	0	13,102	13,102	40,054	13,263	53,317
Textile and Accessories	7	1,973	427	2,400	8,879	46	8,925
Transportation	44	2,014	19,090	21,104	93,454	31,313	124,767
Water and Electricity	13	0	1,755	1,755	140,544	1,071	141,615
<b>Total</b>	<b>700</b>	<b>311,251</b>	<b>232,738</b>	<b>543,989</b>	<b>2,966,342</b>	<b>461,996</b>	<b>3,428,338</b>

Sources: The data were compiled from samples obtained from the Ministry of Finance, November 2003.

## *Discussion*

Since the 1.5 percent tax on turnover is paid each month, it is considered to be a prepayment of the corporate income tax at the end of fiscal year. This tax is credited against the corporation income tax liabilities and the excess amount can be carried forward. The firms appear to be quite content with this system because of its administrative simplicity. The fact that it is applied to all firms, excluding those operating in the free trade zones, means that this turnover tax will be largely passed on to the final consumers. Hence, the incentive for firms to evade the corporate income tax is reduced.

Since firms can deduct the full amount of interest expense on their debt and, at the same time, their depreciation expenses are fully adjusted for the rate of inflation, there is an over compensation for the effect of inflation. This effectively reduces the real amount of income taxes collected during an inflationary period.

If interest expense is fully allowed as a deduction then the cost basis of the assets should be adjusted for inflation only for the proportion of the assets that are financed by equity. To secure this result, an amount equal to the rate of inflation times the amount of net debt (debt less interest bearing financial assets) should be added to the current taxable income. This adjustment, along with the other features presently incorporated in the tax law, provides for a complete and accurate correction for the effects of inflation.<sup>10</sup> This is the practice in most countries of Latin America. As was mentioned earlier, this adjustment is already drafted in the regulations of the Dominican Republic, but it is not implemented by the tax administration.

A version of this correction that would have less of an immediate impact on cash flows would be to allow the full deduction of interest expense while adjusting upward the net book values of depreciable assets by the rate of inflation. In addition, the net book value of depreciable assets would then be reduced by an amount equal to the rate of inflation times the value of the net financial debt held by the company.<sup>11</sup>

Another measure for controlling the amount of interest expense claimed by corporations is to limit the amount of interest expense to half of business profits, measured before interest expense and before income tax (IBIT). This would restrict the amount of the deduction for interest expense in any given year, where the excess of interest expense claimed over interest expense allowed could be carried forward and applied as an expense in following years.

Another issue is whether the corporate income tax can continue to be tax exempt in free zones under the new WTO rules. As of 2007, the same corporate income taxes should be applied to companies operating in the free zones as those located outside the zones. This may not be viable for some firms. For some foreign companies, for instance, from the United States the additional income taxes paid to the Dominican Republic may not be entirely an incremental cost to the firms. The US foreign income tax credit mechanism may allow a reduction in the

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<sup>10</sup> The provisions in the income tax law already include the full adjustment of the net book value of depreciable assets for the rate of inflation and the use of the LIFO accounting rule for the estimation of the cost of goods sold.

<sup>11</sup> This provision was recommended, but not accepted, in the tax reform implemented in the early 1990s.

taxes these firms pay to the US Treasury. For the 1.5 percent turnover tax, the receipts earned from exports should be exempted. The discussion on this topic will be taken further in Section 8.1.

### ***Revenue Impact***

Measure one: If the full amount of nominal interest expenses is allowed as a tax deduction and, at the same time, the impact of inflation on the real value of the firm's debt is also included in the taxable income, then the impact of inflation on the real amount of taxes paid by the companies would be largely neutralized.

As compared to the current situation there would be an increase in revenue due to the increase in taxable income brought about by a reduction in the real value of debt caused by inflation. The value of this adjustment is equal to the rate of inflation times the amount of net financial debt outstanding.<sup>12</sup>

To measure the impact on tax liabilities, a revenue simulation was carried out using the data on the largest 632 corporations. It also took into consideration the fact that the minimum tax of 1.5 percent is applied on the gross sales and no refunds are given for excess withholding. Hence, if a firm has experienced an excess withholding, this would be the first used to offset any increase in tax liabilities. The results of this simulation were then applied to the total number of corporations subject to income taxation.

For a 10.5 percent rate of inflation in 2002, this adjustment would have increased the total corporation income tax collection by RD\$664.5 million for the sampled firms. Since the total corporate income tax revenues of the 632 firms account for 55.17 percent of the total tax revenues collected from all corporations in the nation, the proposed measure would have yielded approximately RD\$1,204 million or 0.31 of one percentage point of GDP for 2002.<sup>13</sup>

Measure two: If interest expense claimed by firms is limited to being not bigger than a half of profits measured before income tax and interest expenses, then an amount of RD\$41.6 million of taxes would be raised from a sample of 572 large firms based on their 2002 levels of income. When the results of the sample firms are applied to all firms in the country, the proposed measure would have generated an additional RD\$53.8 million which is much less than the revenues from measure one. Furthermore, if measure one were implemented in addition to measure two, then the latter would yield even less incremental revenue, because measures one and two are not entirely independent measures.

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<sup>12</sup> The net financial debt is essentially equal to long term debt and short terms loans less the amount of deposits and bonds purchased by the company in question.

<sup>13</sup> For 2001, the inflation rate was about 4.38 percent. The additional tax revenue from this measure would have been RD\$206.6 million for the country as a whole.

#### 4. General Sales Tax

The tax on the transfer of industrialized goods and services (ITBIS) in the Dominican Republic is a consumption type VAT. It was introduced in 1983, one of the first VATs introduced in the Caribbean region. Imports are taxed at the port of entry while exports are zero-rated. It uses the invoice credit method for administration. In 2001, the tax rate was raised from 8 percent to 12 percent.

An examination of the tax code indicates a wide range of goods and services are specifically exempted from the tax.<sup>14</sup> Although the exemptions were tightened in 2000, the list of exemptions still remains wide. They include:

- live animals such as horse, goat, roosters, chickens, ducks, geese, turkeys;
- fresh or refrigerated fish;
- milk and dairy, butter, fresh cheese (not ripped) including cottage cheese
- eggs and honey;
- bread, flour, cereals;
- rice, potatoes, oil and other condiments in general and other industrialized good of first necessary;
- fresh, frozen, dried, and canned, fruits, nuts and vegetables;
- fresh, frozen or dehydrated meat, fish, sea weed; fresh or frozen seafood;
- water in its natural state;
- coffee, chocolate;
- butter, sausage, sausage meats and noodles;
- salt, sugar, and honey;
- works of art by national artists;
- books, newspapers, and paper for newspaper;
- petroleum and its derivatives;
- medicine for human and animal use;
- fertilizer, manure, seeds and animal food;
- fungicides, herbicides, insecticide;
- match; and
- detergents.

In addition to exempt goods produced locally, the following imported goods are also exempt:

- salted cod and herring;
- corn and wheat;
- edible unrefined oils;
- imports by public sector institutions;
- final imports of goods for personal use that are exempted from import duties, subject to special regulations for passenger baggage, disabled persons, immigrants, returning residents, and personnel from the foreign service of the country;

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<sup>14</sup> Horwath, Sotero Peralta & Asociados Members of Horwath International and Russin, Vecchi & Heredia Bonetti L.L.P., *Tax Code of the Dominican Republic*, Title III on the Tax on the Transfer of Industrialized Goods and Services, October 1997.

- final imports made with exemptions in matters of import duties for institutions of the public sector, international organizations of which the Dominican Republic forms a part;
- final imports of samples and parcels exempted from import duties;
- imports of machinery and spare parts for the same raw materials, supplies and equipment and their spare parts made by industrial free zone enterprises; and
- equipment, machines and materials imported by agricultural, industrial, mineral exploitation or public service enterprises that are totally or partially exempt from import duties by means of contracts approved by the National Congress.

There is a threshold for small businesses for filing the ITBIS tax. For those who carry out commercial activities with gross sales less than RD\$2 million a year, they are outside of the system and are, therefore, not required to register or to collect ITBIS from their customers.

When input tax credits are greater than the tax on gross sales, the excess amount shall be transferred as a deduction to the following monthly periods. For exporters, the tax code has a provision to request for a refund for the ITBIS paid on business inputs within six months. However, this system does not seem to be functional in practice.

### *Discussion*

As previously stated, there is a wide range of goods and services that are currently exempt from tax under the ITBIS system in the Dominican Republic. Chile, which has one of the most comprehensive coverage of goods and services subject to the VAT in Latin America, raises 8.5 percent of GDP from VAT. If its 18% tax rate were adjusted to 12%, the revenue would still have been 5.7 percent of GDP,<sup>15</sup> which is about 35 percent more than the 4.2 percent of GDP that collected by the Dominican Republic in 2002. This seems to imply that some potential revenue could be raised by the Dominican Republic if the tax base is broadened and the tax administration is strengthened, even before resorting to raising the rate of ITBIS.

We have examined the trend of the aggregate tax collections from importers and domestic registrants over the past four years as presented in Table 8. The first panel shows the actual tax revenues as a percentage of GDP. Since the ITBIS rate was raised in 2001 from 8 to 12 percent, the tax collected per percentage point of the ITBIS rate and the results are shown separately for domestic and imported goods in the second panel. The revenues collected from domestic registrants declined a bit while the collection of ITBIS from imports was reduced considerably in both 2001 and 2002. The third panel presents the projected tax revenues for 2001 and 2002 if no behavior response would have been taken place as a result of rate change from 8 to 12 percent. We now calculate the marginal impact of the ITBIS rate increase on revenue collection using the average collection level per percentage point of the ITBIS rate for 1999 and 2000 as the norm. If the additional 4 percentage points of the ITBIS had been collected at the same average rate as the initial 8 percent ITBIS in years 1999 and 2000 the index would have value of 1.00. The results show the initial shock of a rate change resulted in a decline of 11 percent in the marginal revenue collections from domestic registrants in 2001

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<sup>15</sup> This is an understatement of the amount of revenue that Chile would collect with a 12 percent VAT because of the increased evasion and avoidance behavior stimulated by the high 18 percent rate of tax, it now levies.

(row 12 column 3) but soon recovered to its average level of 1999 and 2000. For imported goods, however, the effect was much more serious as the Customs collected, at the margin, only 21 percent and 42 percent of the additional tax for 2001 and 2002, respectively. The reduction in tax revenues due to a failure of the Customs service to administer the collection of the ITBIS in 2002 as well as it was done in 1999 and 2000 amounted to RD\$1.69 billion.<sup>16</sup> In fact, this particular loss is only a part of the annual revenue cost that has resulted from the deterioration in recent years of the operational effectiveness of the Customs administration.

**Table 8**  
**ITBIS Collection Efficiency, 1999-2002**

No.	Headings	1	2	3	4
		1999	2000	2001	2002
1	ITBIS as Share of GDP	3.08%	3.09%	3.96%	4.22%
2	Domestic	1.61%	1.65%	2.36%	2.46%
3	External	1.47%	1.43%	1.60%	1.75%
4	ITBIS Rate (Statutory) (%)	8	8	12	12
5	Average ITBIS Collection (per point of ITBIS rate)	0.385%	0.386%	0.330%	0.351%
6	Domestic	0.202%	0.207%	0.197%	0.205%
7	External	0.184%	0.179%	0.133%	0.146%
8	Average Projected Collection as shares of GDP			4.63%	4.63%
9	Domestic			2.45%	2.45%
10	External			2.18%	2.18%
11	Actual Marginal ITBIS Rate Effectiveness Index			0.57	0.74
12	Domestic			0.89	1.01
13	External			0.21	0.42

Notes:

Row 5 = Row 1 ÷ Row 4

Row 6 = Row 2 ÷ Row 4

Row 7 = Row 3 ÷ Row 4

The values in Rows 8, 9 and 10 are estimated under the assumption that the level of administrative effectiveness would be the same in 2001 and 2002 as the average of 1999 and 2000.

Row 8 = [(Row 5 Col 1 + Row 5 Col 2)/2] (12)

Row 9 = [(Row 6 Col 1 + Row 6 Col 2)/2] (12)

Row 10 = [(Row 7 Col 1 + Row 7 Col 2)/2] (12)

Row 11 Col 3 = 1 - (Row 8 Col 3) - Row 1 Col 3 ÷ {[(Row 5 Col 1 + Row 5 Col 2)/2] \* (4)}

Row 11 Col 4 = 1 - (Row 8 Col 4) - Row 1 Col 4 ÷ {[(Row 5 Col 1 + Row 5 Col 2)/2] \* (4)}

Row 12 Col 3 = 1 - (Row 9 Col 3) - Row 2 Col 3 ÷ {[(Row 6 Col 1 + Row 6 Col 2)/2] \* (4)}

Row 12 Col 4 = 1 - (Row 9 Col 4) - Row 2 Col 4 ÷ {[(Row 6 Col 1 + Row 6 Col 2)/2] \* (4)}

Row 13 Col 3 = 1 - (Row 10 Col 3) - Row 3 Col 3 ÷ {[(Row 7 Col 1 + Row 7 Col 2)/2] \* (4)}

Row 13 Col 4 = 1 - (Row 10 Col 4) - Row 3 Col 4 ÷ {[(Row 7 Col 1 + Row 7 Col 2)/2] \* (4)}

<sup>16</sup> This amount was estimated by multiplying the amount of ITBIS collected by the Customs in 2002, RD\$6,898 million, by the ratio of 2.18% to 1.75% less one. The RD\$6,898 million was the actual collections of ITBIS at the Customs in 2002 while 1.75% and 2.18% were the ratio of the actual collections of the ITBIS to GDP, and the ratio that would have been collected as if the customs administration administering the ITBIS as well as they were already doing in 1999 and 2000. See Tables 1 and 6.

A serious set of problems have been created by the fact that the government has maintained a policy of not refunding the over payment of taxes by firms. This is a particularly serious problem in cases where an exporter has accumulated excess ITBIS input tax credits, or has paid import duties on imported inputs that should be refunded.

In light of the need to comply with the World Trade Organization (WTO) regulations for 2007, it is of utmost importance to implement an efficient system for the refund of the ITBIS input tax credits to exporters. There will never be a viable export sector operating outside of the free trade zones if this is not done. Likewise, a system of duty suspension (or importation on bond) must be developed to remove the cost of import duties from the imported inputs used by exporters operating outside of the free trade zones.<sup>17</sup> If this system is not implemented it will be difficult to have a dynamic export sector operating outside of the free trade zones. The system for duty drawback also needs to be made operational for small and new exporters. However, a duty drawback system alone will not provide the timely and efficient system for duty relief on imported inputs that the export sector currently needs in order to be internationally competitive.

Additionally, some features of the ITBIS can be discovered from an examination of a sample of 680 largest tax registrants. The results provide us with a picture of the distribution of the tax base of the ITBIS.<sup>18</sup> Table 9 shows the tax collections and the share of exempt sales by industry. As expected, the exempt sales for cereals, food processing, and milling sectors are high, as most of agricultural products are exempt. Petroleum products are tax exempt too. Water and electricity sectors are also tax exempt. As a result, the percentages of exempt sales in these sectors were as high as 70 percent or even more over the past three and half years. Other sectors such as manufacturing, chemicals and plastics, metal products, construction and services have very high shares of exempt sales.

As there is a wide range of tax exemptions for many types of goods and services, many taxpayers will have a high percentage of mixed (taxable and exempt) sales. This adds administrative complications because the taxpayer should only claim an input tax credit against taxable goods sold. The tendency for the taxpayer is likely to try to utilize some of the excess input tax credits illegally. The ultimate result is that fewer tax revenues are collected than would otherwise be the case.

The second observation from the data is the rising trend in the share of exempt sales by sector. The weighted average of exempt sales reported by sector has increased from 44.7 percent in 2001 to 52.2 percent by the first half of 2003. Even if the petroleum firms were removed from the sample, the weighted average of exempt sales has increased from 33.2 percent in 2001 to 39.4 percent in the first half of 2003.

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<sup>17</sup> We were told by Customs officials that in Regime 9 of Duty Drawback, the system does not operate as it should. In other words, firms do not receive back the amount of import duties paid on business inputs when the final products are exported. In fact, there are a number of ways for the exporters to use the excess input tax credits. For example, firms can use their excess tax credits to pay the ITBIS due on new imports. The compliance costs of these provisions need to be further examined.

<sup>18</sup> The gross sales by sector can be found in Appendix A.

**Table 9**  
**Actual ITBIS Collection and Exempt Sales by Sector, 2000-2003**  
**(thousands of RD pesos)**

Sectors	Actual ITBIS Collections				Share of Exempt Sales			
	2000	2001	2002	2003*	2000	2001	2002	2003
Agriculture	0	1,460	1,786	0	0.0%	0.0%	0.0%	N/A
Cereals	0	0	0	0	92.6%	85.1%	70.1%	N/A
Chemical Products	186,035	274,039	486,581	305,049	38.2%	39.0%	38.4%	41.2%
Commerce	661,314	674,254	648,310	409,390	23.6%	26.4%	26.5%	30.6%
Communication	161,045	192,648	248,203	152,489	30.9%	29.9%	30.2%	41.0%
Construction	6,242	13,541	20,548	16,952	31.1%	58.1%	62.5%	62.0%
Education	0	4	1,789	0	10.8%	40.5%	58.0%	N/A
Financial Intermediation, Insurance, and Financial Services	32,759	454,073	602,517	514,216	67.6%	32.9%	41.0%	51.2%
Food Processing	116,748	162,400	134,051	120,758	71.9%	68.1%	69.2%	70.8%
Health	104	1,726	2,939	0	52.7%	37.6%	44.8%	N/A
Hotels and Restaurants	232,909	351,783	469,770	415,796	7.0%	15.1%	21.5%	21.8%
Machinery and Electrical Appliances	1,844	0	2,477	0	0.0%	23.4%	5.6%	N/A
Manufacturing	146,724	203,593	228,035	164,506	12.6%	15.5%	18.0%	18.9%
Metal Products	86,647	77,899	80,766	129,162	17.0%	21.7%	26.9%	27.9%
Milling	13	37	101	339	95.8%	95.7%	97.2%	97.0%
Mining	0	0	0	0	N/A	98.0%	95.2%	N/A
Miscellaneous Non-Metal Products of Mineral Origin	1,146	1,225	1,203	0	0.6%	7.5%	8.0%	N/A
Miscellaneous Services (Medical, Casino, etc.)	3	3,674	4,713	6,366	73.2%	67.0%	71.7%	N/A
Non-Metal Products of Mineral Origin	95,420	84,278	88,002	72,088	5.1%	7.3%	9.0%	19.1%
Oil Refinery	3,412	14,591	22,943	21,288	99.1%	93.2%	92.0%	98.2%
Petroleum Products	0	8	128	0	98.4%	97.8%	97.4%	N/A
Plastics	810	4,555	3,261	0	0.0%	15.9%	34.7%	N/A
Production of Sugar	0	0	0	0	96.9%	97.9%	98.0%	93.7%
Production of Tobacco and Beverage	815,389	1,008,150	1,005,146	543,295	4.7%	5.7%	7.6%	9.1%
Products of Rubber and Plastics	59,173	67,261	77,178	37,892	8.4%	11.8%	13.7%	17.9%
Services to Enterprises	13,113	99,321	139,084	108,428	54.4%	15.4%	13.7%	6.7%
Textile and Accessories	24,270	20,266	22,370	16,397	3.8%	1.6%	0.2%	0.6%
Transportation	1,177	295,452	315,320	238,059	2.7%	26.0%	30.3%	38.4%
Water and Electricity	0	100	42	34,860	N/A	93.7%	99.5%	92.9%
<b>Total and Average, 680 Companies</b>	<b>2,646,296</b>	<b>4,006,337</b>	<b>4,607,262</b>	<b>3,307,331</b>	<b>44.7%</b>	<b>46.7%</b>	<b>44.1%</b>	<b>52.2%</b>
<b>Total VAT Collection, All Companies Except Oil Refineries and Petroleum Products</b>	<b>2,642,883</b>	<b>3,991,739</b>	<b>4,584,192</b>	<b>3,286,042</b>	<b>30.8%</b>	<b>33.2%</b>	<b>35.2%</b>	<b>39.4%</b>
<b>Total VAT Collection, All Companies</b>	<b>5,407,686</b>	<b>9,114,090</b>	<b>9,785,775</b>					
<b>Share of 680 to All Companies</b>	<b>48.9%</b>	<b>44.0%</b>	<b>47.1%</b>					

Note: \* The data for 2003 covers the first two quarters of the year.

For revenue and administrative reasons, the Dominican Republic should limit its list of the exempt goods and services. However, bringing gasoline and other oil products into the ITBIS system may be difficult because the government collects even more revenue by exempting these items from the ITBIS and keeping them subject to excise taxes. We recommend the ITBIS exempt list only include:

- live animals;
- basic groceries including meat, fish, milk, butter, cheese, rice, potatoes, corn, bread, cereals, flours, grains, wheat, corn, beans, fruits, nuts, vegetable;<sup>19</sup>
- plants for sowing;<sup>20</sup>
- gas and diesel oil;
- a list of essential drugs prescribed by medical doctors;
- electricity;<sup>21</sup>
- deposit-taking and other financial services other than insurance for technical reason that virtually no country in the world has taxed this sector;<sup>22</sup> and
- some social services for not commercial purpose such as education, and health services because of the difficulty in measuring the price of output. The exceptions are services provided by private schools and private clinics for the purpose of profit making.

There should not be any exemption allowed for imports made by government departments or other public institutions. This would remove the bias in favor of imported items and also help to avoid any abuse of the system.

Moreover, one of the provisions under the current ITBIS legislation provides for an exemption of a good under certain circumstances. In fact, whether a good is tax exempt or not under the ITBIS should not be tied to its exemption from import duty. This form of exemption provision should be eliminated.

Currently, air transportation tickets, telephone services, and insurance premiums are included in the ITBIS. Previously they were subject to excise taxes. The insurance sector is notoriously difficult to tax under either an income tax system or a value added tax. Under a value added tax, it is likely that significant excess tax credits will be generated in these activities that will be used to reduce taxes elsewhere. It would be our recommendation to exempt the insurance industry from the ITBIS and, instead, to impose a 10 percent excise tax on all insurance premiums.

The real cost of provision of telephone services has fallen significantly in recent years. In particular, the cellular telephone usage has become widespread. These innovations have resulted in very significant benefits to consumers. It would seem reasonable to have a low

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<sup>19</sup> As a result, animal or vegetable oil, salamis, coffee, tea, water, sugar, salt, cocoa, chocolate, ketchup, vinegar, fertilizer, insecticides, books, soap, match, detergents, mineral products and computer equipment should all become taxable.

<sup>20</sup> Including harmonization codes 06.01 and 06.02.

<sup>21</sup> This sector is being subsidized.

<sup>22</sup> Taxing insurance services, especially life insurance, is theoretically problematic under a value added tax. In all simulations under the ITBIS, we keep it taxable but will calculate the incremental revenue implications if an excise tax, rather than the ITBIS, on insurance premiums were imposed.

excise tax of 10 percent levied on the telephone bills in addition to the current 12 percent ITBIS.<sup>23</sup>

In the case of airline tickets, the main problem of taxing them under the ITBIS is the control of tax credits generated. It is almost impossible to separate business trips from trips taken for pleasure. Hence, to reduce the leakage of revenue, which appears to have taken place by the recent replacement of excise tax on air travel by ITBIS, we would recommend levying a 10 percent excise tax on the sale of airline tickets and exempting them from the ITBIS.

We have not estimated the revenue impacts of the above three proposed changes in Table 10 as part of the proposed changes to the ITBIS, but incorporated their revenue impact into the proposed changes to the excise tax system.

### ***Revenue Impact***

We have used a data sample of largest 680 companies to simulate the revenue implications of the proposed measures. The results are shown in Table 10. The exemptions were restricted as proposed. Since the taxable sales have increased, business inputs used to produce taxable sales are also increased, and so are the tax credits on business inputs. In the case of a firm where input tax credits are greater than the ITBIS collected on taxable sales, the simulation assumes that no refunds are given. In other words, no net additional ITBIS is collected from such firms. The revenue gains from the proposal would have been RD\$754 million for 2000, RD\$1,274 million for 2001, and RD\$1,505 million for 2002, respectively.

The revenue collection from the largest 680 firms accounted for 48.9 percent, 44.0 percent, and 47.1 percent of the total ITBIS revenues collected from all registrants in the country in year 2000, 2001, and 2002, respectively. If the 47 percent is used as a base, the proposed reform would have yielded RD\$3.2 billion for 2002. Suppose the overall compliance ratio was 70 percent, the proposal would have likely generated additional revenue of about RD\$2.24 billion in 2002 prices, or 0.57 of one percentage point of GDP.

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<sup>23</sup> If this proves too difficult to implement politically, a 10 percent excise tax should be imposed only on cellular phone services in addition to the current 12 percent ITBIS on all telephone services.

**Table 10**  
**Potential ITBIS Revenues from Proposed Tax Base Expansion, 2000-2002**  
**(thousands of RD pesos)**

Sector	Current ITBIS Revenues			Gains from Proposed Reform		
	2000	2001	2002	2000	2001	2002
Agriculture	0	1,460	1,786	0	0	0
Cereals	0	0	0	0	0	0
Chemical Products	186,035	274,039	486,581	143,293	339,936	404,622
Commerce	661,314	674,254	648,310	158,998	306,321	311,946
Communication	161,045	192,648	248,203	76,793	101,302	153,992
Construction	6,242	13,541	20,548	2,869	12,262	100,286
Education	0	4	1,789	180	1,482	5,148
Financial Services and Insurance	32,759	454,073	602,517	0	0	0
Food Processing	116,748	162,400	134,051	258,711	271,115	222,042
Health	104	1,726	2,939	0	4,578	6,707
Hotels and Restaurants	232,909	351,783	469,770	23,776	47,489	76,707
Machinery and Electrical Appliances	1,844	0	2,477	0	3,618	776
Manufacturing	146,724	203,593	228,035	37,363	59,181	83,898
Metal Products	86,647	77,899	80,766	16,067	28,063	34,912
Milling	13	37	101	2,418	3,485	13,152
Mining	0	0	0	0	0	0
Miscellaneous Non-Metal Products of Mineral Origin	1,146	1,225	1,203	19	155	169
Miscellaneous Services (Medical, Casino, etc.)	3	3,674	4,713	125	232	215
Non-Metal Products of Mineral Origin	95,420	84,278	88,002	5,846	9,787	13,595
Oil Refinery	3,412	14,591	22,943	0	0	0
Petroleum Products	0	8	128	0	0	0
Plastics	810	4,555	3,261	0	0	226
Production of Sugar	0	0	0	2,540	0	0
Production of Tobacco and Beverage	815,389	1,008,150	1,005,146	0	0	0
Products of Rubber and Plastics	59,173	67,261	77,178	5,749	8,809	8,997
Services to Enterprises	13,113	99,321	139,084	18,182	26,875	29,286
Textile and Accessories	24,270	20,266	22,370	1,200	228	68
Transportation	1,177	295,452	315,320	40	48,829	38,429
Water and Electricity	0	100	42	0	0	0
<b>Total (680 Companies)</b>	<b>2,646,296</b>	<b>4,006,337</b>	<b>4,607,262</b>	<b>754,166</b>	<b>1,273,745</b>	<b>1,505,174</b>

## 5. Excise Taxes

The selective taxes on consumption in the Dominican Republic are, in fact, the same as what are called excise taxes elsewhere in the world. They are levied on certain goods produced domestically as well as imported. These goods include alcoholic beverages, cigarettes and other tobacco products, petroleum, vehicles, jewelry, and many other products.

During the 1990s, the tax rates were different for domestically produced goods than for similar imported goods because their tax bases were quite different. The former was levied at the retail level while the latter was based on their duty-paid values. Because of the difficulty in enforcing the tax collections at the retail level, the tax base was moved to the manufacturing or wholesales level equivalent, at least in theory. The tax rates for the same commodity are the same whether produced locally or imported.

To facilitate the administration of excises, the taxes are currently levied on the manufacturers rather than on retailers. This is also consistent with the WTO rules for equal treatment between domestic and imported goods. As a result, the government adjusts the manufacturers' tax base prices of excisable goods by various mark-up percentages using an official Central Bank price survey in order to equalize the duty-paid value of imported and similar domestically produced goods. For example, the mark-up percentages of alcoholic beverages and tobacco products and their tax rates are listed below:

	<u>Mark-up</u> <u>(%)</u>	<u>Tax Rate</u> <u>(%)</u>
Wine	30	35
Beer	30	25
Whisky, Vodka	30	45
Rum	30	35
Other Liquor	30	45
Other beverages	30	30
Cigarettes	20	50
Cigars	20	25

The domestically produced goods subject to excise taxes include only alcoholic beverages and tobacco products. For imports, however, excise taxes are also imposed on vehicles and their parts, jewelry, cosmetics, rugs, microwave ovens, air conditioners, and so on. It appears that a policy of domestic protection from imports has also found its way into the excise tax system. While the Customs collects excises on a list of some 150 commodities, the domestic excises are only collected on alcohol and tobacco products. The practice of the Tax Administration has been to avoid collecting the tax on the rest of the excise list due to administrative reasons and insignificant volume of domestic production.

A special attention must be paid to the excise tax on vehicles. The statutory tax rates increase as the prices of vehicles rise. It seems to be a very progressive tax, and its current rate schedule is shown in Table 11.

**Table 11**  
**Excise Tax Schedule for Vehicles, 2003**

Price of Vehicle at FOB Value (US\$)	Excise Tax Rates (%)
0 to 15,000	0
15,001 to 30,000	15
30,001 to 40,000	30
40,001 to 50,000	45
50,001 to 60,000	60
60,000+	80

In addition to physical goods, excise taxes are also levied on telecommunication services at 2 percent, payable to the telecommunications regulatory body. Prior to 2001, the excise tax was collected from long distance communication services at 10 percent, international air transportation services at 20 percent, all insurance premiums at 10 percent and hotels at 5 percent.

***Discussion***

After moving the excise tax from the retail level to the manufacturing level for alcoholic beverages and tobacco products, the tax system appears to be working more effectively. This is especially the case for tobacco products. The tax revenues more than doubled from 2000 to 2001. A remaining issue is whether the percentage mark-ups for respective excisable commodities are adequate and how frequent they should be adjusted.

When we consider the excise tax rates, especially on cigarettes and also on beer of 50 percent and 25 percent, respectively, of their imputed retail price, we find that they are relatively low by international comparisons. In the case of cigarettes, the low rates of excise tax appear to be neither a good tax policy nor a proper health policy.

The other issue is trade liberalization that in the future would lower the import duty rates and, hence, the tax base of excisable goods. We would recommend an adjustment of excise duty rates in order to keep the retail prices of the excisable goods unchanged. This will be discussed in the Section 6.3. As a result, the revenues from the excise tax imposed on domestically produced alcoholic beverages and tobacco products will increase.

The sales volume and tax liability of domestically produced excisable goods in 2002 are shown by commodity in Table 12.

**Table 12**  
**Sales of Domestic Excisable Goods, 2002**

Excisable Goods	Quantities	Amount (thousands of RD pesos)		
		Sales	Taxable sales	Tax Liabilities
Wine, Liquor	796,804	227,911.0	296,284.3	103,699.5
Brandy, Cognac	3,339,194	446,185.8	577,277.3	259,774.8
Rum and other drinks	4,687,623	1,222,384.7	1,589,113.1	520,550.3
Fermented Beverages	297,639	62,324.5	81,021.8	24,306.5
Beer	31,454,152	7,504,977.8	8,225,915.6	2,252,093.3
Other Beverages	116,009	2,256.4	2,933.3	1,320.0
Cigars	1,474,741	27,007.6	814,861.9	8,102.3
Cigarettes	15,230,430	1,774,865.1	2,129,838.2	1,064,919.1
Others	--	--	--	36.1
<b>Total</b>	<b>--</b>	<b>11,267,913.0</b>	<b>13,717,245.5</b>	<b>4,234,801.9</b>

The excise tax on vehicles may be perceived as a progressive tax in because the marginal statutory tax rates increase as the prices of vehicle go up (see Table 11). As a matter of fact, the effective tax rates as a percentage of import duty-paid collected by tax bracket is surprisingly low for 2002 with an average effective rate of 1.58 percent (Table 13).<sup>24</sup> It is interesting to note that the effective tax rate for the most expensive vehicles was lower than other categories of vehicles. This implies that a substantial tax leakage is occurring in the case of vehicles.

The system of excise taxes on automobiles is in a dire need of significant reform. The lower import prices are being used as the tax base when an automobile imported by a car dealer as compared to private individual is a source of manipulation. Individuals simply can make an arrangement with a dealer to import the vehicle. Furthermore, the progressive rate of excise taxes provides a huge incentive for importers to make deals with Customs officials to lower the price in order to avoid the progressive excise tax burden. We also find that many luxury vehicles are finding their way into the country via some type of exempt provision.

In the immediate future the most suitable solution seems to be a replacement of the current structure of excise rates on vehicles with a relatively low simple rate of excise tax on the CIF price plus import tariff on all vehicles, plus a reduction of the price differentials between cars imported by automobile dealers and those imported directly by individuals.

<sup>24</sup> From different data files obtained from the Customs, we have also calculated the effective excise tax rates by regimes as shown in Appendix B1. The average aggregate rate was about 1.78 percent, slightly higher than the figure presented in Table 13. It is also important to observe that the effective rates by resolution, as shown in Appendix B2. It is clear that there is significant tax relief on vehicles as a result of the existing resolutions. The definition of various resolutions can be found in Section 6.4.

**Table 13**  
**Volume of Imports and Average Effective Excise Tax Rates for Vehicles, 2002**

Price of Vehicle (FOB @US\$)	Tax Rate (%)	Import at FOB Value (US\$ thousands)	Import at CIF Value (RD\$ millions)	Import Duty (RD\$ millions)	Excise Tax (RD\$ m)	Average Effective Excise Tax Rate (%)
0 to 15,000	0	329,490.6	6,412.0	1,282.3	0	0
15,000 to 30,000	15	166,733.8	3,273.6	654.4	106.4	2.71
30,001 to 40,000	30	37,916.9	741.2	148.2	46.6	5.24
40,001 to 50,000	45	16,580.6	316.7	63.2	33.8	8.90
50,001 to 60,000	60	4,431.3	84.1	16.7	9.5	9.42
60,001+	80	14,878.1	290.2	57.7	14.1	4.05
<b>Total</b>	-	<b>570,031.2</b>	<b>11,117.8</b>	<b>2,222.5</b>	<b>210.4</b>	<b>1.58</b>

In regard to taxation of telecommunication services, discussed in Section 4, we recommend an excise tax of 10 percent to be imposed on all telecommunication services. This measure, if implemented, would have generated an additional tax revenue of RD\$1.91 billion in 2002 prices, or 0.48 percent of GDP.<sup>25</sup>

In the case of airline tickets, we recommend to levy a 10 percent excise tax on the sales of airline tickets and to make them exempt from the ITBIS. The former measure would have risen more than RD\$363 million in 2002 while the latter would lose some revenue. The net results would be some incremental tax revenues generated from these measures.<sup>26</sup>

Finally, in the case of insurance, if a 10 percent had been imposed on insurance premiums, it would have raised RD\$619 million in 2002. However, exempting the insurance services under the ITBIS as proposed would lose a substantial amount of the tax revenue currently collected from the sector. At the same time we do not know how much of the ITBIS is currently used as an input tax credit of business expenses. The net revenue could amount to, at least, RD\$250 million.<sup>27</sup>

<sup>25</sup> In 2002, the total gross income of telephone companies was RD\$19,134 million.

<sup>26</sup> In 2002, the total gross income of the passenger and cargo services was about RD\$5,137 million, of which passenger services were about RD\$3,634 million. The proposed excise tax would have generated RD\$363.4 million, but exempting the ITBIS would have lost some revenues.

<sup>27</sup> In 2002, the Government collected RD\$555 million from taxing the insurance services under ITBIS, of which, we assume, about two-thirds would have been forgone if it was exempted. The RD\$555 million figure was obtained from the sample of the 680 largest firms mentioned in the section of the general sales tax.

## **6. Tax Reform and System for Taxation of International Trade Transactions**

Following the recent trends of trade liberalization worldwide, the rates of import duty have fallen over time in the Dominican Republic too, especially in 2001. This is particularly important for the country, as it is planning to engage into a free trade agreement with the U.S. in 2004.<sup>28</sup> If the Dominican Republic is planning to enter into such a free trade agreement, then it will need to develop a strategy to move to a zero tariff situation over time. Because it currently collects over 16 percent of its total revenues from tariffs on imports, other parts of the tax system needs to be changed and strengthened to fill the revenue gap created by lowering and eventually eliminating the tariffs. Recent events have forced the government to impose “temporary” measures that moved the taxation of international trade exactly into the opposite direction to where it plans to go.

To recover the tariff revenue foregone due to a reduction of import duty rates, the Government imposed a commission on all foreign exchange used to purchase imported goods since 1999. On July 1, 2003, the Government imposed an additional 2 percent temporary import duty rate on all imported goods. Furthermore, the commission on foreign exchange was also increased on October 23, 2003 from 4.75 percent to 10 percent as a temporary measure.

The rest of this report will present an analysis of the current situation and discussion of a series of measures that will allow the government to contain the size of its budget deficit while moving to a situation where free trade exists between the US and the Dominican Republic.

### **6.1 The Current System**

#### ***An Overview***

In terms of import duty provisions in the Dominican Republic, there are mainly three classifications of imports. First, there are those imports destined for the free trade zones. These enter duty free because the zones are considered for purposes of customs and taxation to be located outside of the country. All such imports are not taxed when they enter the zones and no goods are taxed when exported from the zones unless they are being sold within the domestic economy. The second category is imports originating from other Caribbean countries, Central America or covered by other bilateral trade agreements. In this category imports are largely exempt from the duty. These represent a very small amount of the Dominican Republic’s international trade. The third category is imports from other than the first two categories. These items attract import duties.

For calendar year 2002, the data on the total amount of imports and import duties collected by the Customs are organized into 15 regimes. They are summarized in Table 14. Regime 1 is the most important one as it accounts for more than three-quarters of the total imports in the country. The next important category is free zones (Regimes 10 and 11), which account for

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<sup>28</sup> For example, at the time of preparing this report the U.S. has requested the Dominican Republic to have a zero rate of import duty on 49 percent of the total 6,772 import duty lines in the Harmonized code plus additional 1,287 import lines, with a zero rate for a total of 4,605 import on items with zero rates of tariff.

21.5 percent of the total volume of imports. It should be noted that import duties and other tax revenues reported by the Customs were not the actual revenue collection since some tax revenues were recorded but not collected. The information has not been subsequently adjusted in the Customs statistics. For example, the total amount of import duties was recorded at RD\$13,559 million while the actual collections were RD\$11,211 million.<sup>29</sup> The weakness of the existing record-keeping system has imposed some difficulties for our analysis.<sup>30</sup>

In addition, there are 20 resolutions that provide various exemptions of import duty at the discretion of the government, and their effect will be discussed in Section 6.4. However, one of them is the free trade or bilateral agreements with Caribbean or other countries (Regime 18) that will not attract any import duty in the future. For the purpose of this analysis, this is classified in the second category mentioned above. As a result, the total imports from the three categories are shown below expressed in millions of pesos:

	<u>Imports at CIF Value</u>
Imports into Free Zones	29,604
Imports from Countries with Free Trade Agreements	1,032
The Rest of Imports	<u>106,394</u>
Total	137,030

The total actual collection of import duties in 2002 was about RD\$11,211 million, of which only about RD\$48 million was collected from the Caribbean countries and other countries with free trade or bilateral agreements. In the future, imports from these countries would most likely remain free from import duties. We will focus our analysis here on imports other than those coming into the free zones or originating from countries that have free trade or bilateral trade agreements with the Dominican Republic.

Import duties are one of the most important sources of tax revenues in the Dominican Republic, accounting for about 16.9 percent of total revenues in 2002. The revenues, however, have been reduced deliberately due to trade liberalization. This was most apparent in 2001 and this trend is expected to continue because of the free trade negotiations with the United States.

In addition to the import duties, a substantial amount of revenue is also collected from the commission charged on foreign exchange transactions used to purchase imports. In 2002, the revenue amounted to RD\$2,989 million, in addition to approximately RD\$1,744 million is earmarked to service the Central Bank's external debt.<sup>31</sup>

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<sup>29</sup> See Table 1.

<sup>30</sup> From what we have experienced in undertaking this study, the quality of economic analysis would be greatly improved in the Dominican Republic if the Customs administration spent more resources in improving the quality of the trade statistics, and the Ministry of Finance had a professional tax analysis and policy group who could work with and clean the information obtained from the Tax Administration and Customs. In fact, the quality of economic data is not as good as available in much poorer countries such as Bolivia, or much smaller countries such as Belize and Barbados.

<sup>31</sup> The rate of commission charged on foreign exchange was 4.75 percent in 2002. The amount of RD\$1,744 million was equivalent to the 1.75 percentage points.

**Table 14**  
**Volume of Imports and Import Duties by Regime, 2002**  
(millions of RD pesos)

Regimes	Import at CIF Value	Import Duties*
1. Consumption	103,962.6	8,576.7
2. Temporary Import (repackaging)	947.3	56.0
3. Temporary Import (do nothing)	690.2	55.0
4. Temporary Leasing	81.7	8.0
5. Temporary Imports, Export for Fixing, and then Imports	0	0
6. Temporary in Warehouse	1,420.9	258.1
7. Import and then Re-export	108.1	17.4
8. Temporary Admission	30.7	3.8
9. Duty Drawback	0.5	0.1
10. Free Zones – Commercial*	1,191.6	111.4
11. Free Zones – Manufacturing*	28,412.7	4,447.0
12. Transito Internacional	3.0	0.0
13. Items subject to Temporary Surcharges at 10% Tariff	143.5	20.4
14. Reimportacion	34.8	2.0
15. Deposito Particular	12.0	3.0
<b>Total</b>	<b>137,029.6</b>	<b>13,559.0</b>

Sources: Customs Department of the Ministry of Finance, Dominican Republic, November 2003.

Note: \* The firms located in the free zones would purchase imported goods free of import duty. The import tariff figures shown here were recorded in the Customs statistics but not necessarily collected.

### ***Import Tariff Structure***

Over the past years, the number of tariff rates has been reduced in the Dominican Republic. At present, there are 8 duty rates imposed on all imported goods. These rates are 0, 3, 8, 14, 15, 20, 25, and 40 percent. The types of commodities subject to import duty rates are summarized as follows:

- 0% rate:* medicine, books for school, corn, and inputs used for agricultural production such as fertilizers, farming machinery and equipment, computer equipment.
- 3% rate:* broad materials used for industrial production.
- 8% rate:* intermediate inputs used for industrial production.
- 14% rate:* semi-processed products, fish, milk substitutes, butter, dried vegetables.
- 15% rate:* De Cana, arroz con cascara (harmonization codes: 1701.11.00 and 1006.10.00).
- 20% rate:* consumption goods such as textile products, phone and photo equipment, vehicles, garlic, onion, rice, powdered milk, sugar.
- 25% rate:* agricultural products such as poultry bean.
- 40% rate:* meat products such as sausage, ham, meat.

It should be noted that an additional 2 percentage points of import duty rate was imposed on all imported goods as a temporary measure since July 1, 2003.

In addition to import tariffs, there are quotas imposed on certain imported goods. These goods include garlic, rice, sugar, poultry, onions, beans, powdered milk, and corn. When the volume of these specific goods brought into the country by a particular importer are greater than the respective quota, the import duty rates become extremely high. For example, if a shipment of garlic is more than 4,200 metric tons in 2003, the rate of import duty increases from 20 percent to 101 percent. See Appendix C.

### ***Commission on Foreign Exchange***

A commission was introduced in 1999 on all foreign exchange purchases at a rate of 1.75 percent. The rate was subsequently increased to 5 percent in October 1999, and then reduced to 4.75 percent in October 2001. The amount of revenue has been substantial. The total amount of revenues raised by the foreign exchange commission was about RD\$3,360 million, 3,234 million, and 4,733 million for year 2000, 2001, and 2002. These amounts were equal to 24.3, 33.6 and 36.5 percent of the import duty revenues in these years.<sup>32</sup> In August 2002, a resolution eliminated the commission on foreign exchange transactions and designated the Customs as the agency in charge of collections. This implies that, thereafter, only imported goods are subject to the foreign exchange commission. The rate of this tax was 4.75 percent until October 22, 2003. Since then, the rate has been increased temporarily to 10.00 percent. Clearly, this charge is simply a revenue generation measure.

It should be noted that import duties are applied on top of the CIF value of imports. Excise taxes, with the exception of the excise taxes on automobiles, are levied on top of CIF value plus the regular import duty, but excluding the 2 percent of the import duty surcharge. The excise tax on automobiles is applied directly on the CIF value, excluding any tariffs. Similarly, ITBIS is applied on the CIF value, plus import duty (excluding 2 percent temporary surcharge) plus excise tax.

### ***Export Charges***

The government collects a small amount of export duties for about RD\$2 million per year. In October 2003, the government also imposed 5 percent on exported goods including those from free zones. However, this provision is being reconsidered.

### ***Resolutions***

In contrast to raising revenue, there are 20 resolutions that provide import duty exemptions to various institutions. These resolutions can be grouped in the following categories based on either the purchaser of imported goods or the purpose of concessions. Some of the relief may not appear to be very straightforward.

- government departments;
- non-government organizations;

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<sup>32</sup> The 36.5 percent figure is calculated as a ratio of the total commission on foreign exchange (the sum of RD\$2,989 million plus RD\$1,744 million) to the total import duties (RD\$11,237 million) plus the total commission on foreign exchange.

- embassy purchases;
- promotions for tourism;
- cooperatives for government employees;
- diplomats;
- promotion for agriculture;
- promotion for textile manufacturing;
- educational bodies;
- household items for returned Dominican Republicans after living abroad for 2 years;
- medical laboratory; and
- Free Trade Area of the Americas.

## **6.2 Reform of Import Tariffs on Non-Excisable Goods**

With the pressure from the free trade negotiation with the U.S. and more trade liberalization movement in the region, there is a need to examine the potential revenue impacts if tariff rates are lowered and the structure is simplified.

There is the excise tax on the domestic production of alcoholic beverages and tobacco products; for imported goods more commodities are also subject to the excise tax. Since 2001, the rates of excise tax on imports of these goods are the same as the tax rates on the domestic production of the same goods. As an excise tax is imposed on certain goods and services due to health, environment or other concerns, we treat them differently from other commodities.

As a first step towards a structural reform of taxes on international trade, we would recommend that the import duties on the currently excisable goods be reduced to 10 percent and then adjust the excise tax rate in order to keep the retail prices inclusive of the ITBIS unchanged. For a detailed proposal in regard to excisable imports, refer to Section 6.3.

In 2002, non-excisable goods accounted for 91.1 percent of the total imported goods.<sup>33</sup> During the last decade, the rates of tariff have been reduced across all commodities.<sup>34</sup> Since we are using a complete set of data for 2002, we will use the tariff structure at that time as our starting point without taking into consideration the recent temporary measures and present all the simulation results expressed in the price level of 2002.

In undertaking this analysis we thought that it would be realistic to think of the adjustment of the tariff rates taking place over, at least, a few phases or time periods. To eliminate cascading and to simplify the system, we recommend in Phase I to reduce the foreign exchange commission (from its current level of 10 percent) by 4.75 percentage points; to add a 5 percent rate of tariff on all imported goods; and to have a structural reform of the tariff rates. In other

<sup>33</sup> In 2002, the amounts of excisable and non-excisable goods at CIF value were RD\$12,109 million and RD\$125,021 million.

<sup>34</sup> For example, the average tariff rate for textile and apparel products declined from 25.9 percent in 1990-98 to 8.9 percent in 2001; for chemical products and substance, the rate declined from 21.8 percent to 11.2 percent. See the Economic Commission for Latin America and the Caribbean (ECLAC) Subregional Headquarters for the Caribbean, "The Fiscal Implications and Macroeconomic Effects of Trade Liberalization – The Dominican Republic", a confidential report, January 2003, pp.5-9.

words, there would be only four tariff rates: 5, 10, 15, and 20 percent. That is, raising the bottom rates from 0 and 3 percent to 5 percent; raising the rate of 8 percent to 10 percent; consolidating the rates from 14 and 15 percent to 15 percent; and consolidating the rates from 20 percent and higher to 20 percent. In Phase II, we would propose to reduce the top 20 percent rate to 15 percent in order to have a three-rate structure of import duties. In Phase III, all tariff rates on non-excisable goods are pushed down to zero. The necessity for another phase arose recently after the foreign exchange commission rate was elevated to 10 percent. Since the customs dataset of year 2002 does not have the 10 percent commission simply because it was not administered at the time, and since the removal of 4.75 percent foreign exchange commission has been already accounted for in Phase I, then Phase IV is devised for analytical purposes in order to estimate the impact of a further loss of foreign exchange commission. Thus, Phase IV analyzes a situation when an additional loss of foreign exchange commission is assumed, based on a 5.25 percent rate of taxable CIF imports volume.

Because Regime 1 is the most important one of the total imports in the country and since all resolutions are considered special cases that will be analyzed separately, the current simulation will first deal with Regime 1 in the absence of all resolutions. Bear in mind that the original customs data were adjusted for a number of inconsistencies before attempting to model the revenue implications of the proposed rate changes. The simulation results are shown in Table 15.

The third column of Table 15 presents the current revenues from import duties by tariff rate. They may not be exactly the same amount of duties collected as reported by the Customs because of the corrections made to the raw data.<sup>35</sup>

This reform would reduce the distortionary impact of the tariff system because the rates of tariff are reduced in conjunction with the removal of the 4.75 percent commission charged on foreign exchange transactions in 2002. The gain in tax revenues would be approximately RD\$1,520 million from imported goods. However, this gain would be largely over weighted by the loss of RD\$3,606 million of the commission charged on foreign exchange transactions in 2002.<sup>36</sup> Thus, the net loss would be about RD\$2,086 million in 2002 prices, or 0.53 of one percentage of GDP.

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<sup>35</sup> The corrections are made because of inconsistency between the import value, duty rate and import duties reported.

<sup>36</sup> The revenues forgone from the foreign exchange commission do not include the revenues from the foreign exchange commission on import of excisable goods.

**Table 15**  
**Tariff Restructure and Potential Government Revenues for**  
**Non-Excisable Commodities of Regime 1,**  
**Excluding all Resolutions in Phase I (2002 prices)**

<b>Current Import Duty Rates (percent)</b>	<b>Import Value (RD\$million)</b>	<b>Import Duties (RD\$million)</b>	<b>Proposed Import Duty Rates (percent)</b>	<b>Potential Duty Revenues (RD\$million)</b>
0	15,841	0	5	2,170
3	27,558	827		
8	7,992	639	10	799
14	5,532	774	15	833
15	23	3		
20	18,493	3,699	20	3,792
25	372	93		
40	96	38		
<b>Total</b>	<b>75,908</b>	<b>6,074</b>	<b>--</b>	<b>7,594</b>
4.75% Foreign Exchange Commission		3,606		0
<b>Grand Total</b>		<b>9,680</b>	<b>--</b>	<b>7,594</b>
<b>Total as Percentage of GDP</b>		<b>2.46</b>	<b>--</b>	<b>1.93</b>

People importing goods of the first group at the 5 percent rate would bear a slight increase of import duty because they are effectively subject to a net increase of 0.25 percent in tariff rate. This is a result of an additional tariff rate of 5 percent, but relieved from the 4.75 percent of commission charges on imports in 2002. All other imports in the higher rate bracket would, in fact, bear less duty. The system would also be simpler and more transparent.

The proposed tariff rate changes might be considered as the first phase of a tariff reduction program. In Phase II, we propose to reduce the top 20 percent rate to 15 percent in order to have a three-rate structure of import duties. If this were done then total tariff revenues from non-excisable commodities would be RD\$6,646 million, or a drop in revenue of RD\$948 million or 0.24 of one percentage point of GDP from Phase I. The revenue implications by tariff bracket are presented in Table 16.

**Table 16**  
**Tariff Restructure and Potential Government Revenues for**  
**Non-Excisable Commodities in Regime 1**  
**Excluding all Resolutions in Phase II (2002 Prices)**

<b>Current Import Duty Rates (percent)</b>	<b>Import Value (RD\$ million)</b>	<b>Import Duties (RD\$ million)</b>	<b>Proposed Import Duty Rates (percent)</b>	<b>Potential Duty Revenues (RD\$million)</b>
0	15,841	0	5	2,170
3	27,558	827		
8	7,992	639	10	799
14	5,532	774	15	3,677
15	23	3		
20	18,493	3,699		
25	372	93		
40	96	38		
<b>Total</b>	<b>75,908</b>	<b>6,074</b>	--	<b>6,646</b>
4.75% Commission on Foreign Exchange		3,606	--	0
<b>Grand Total</b>		<b>9,680</b>		<b>6,646</b>
<b>Total as Percentage of GDP</b>		<b>2.46</b>	--	<b>1.69</b>

When the same kind of exercise is extended to all other regimes, we can summarize the simulation results as shown in Table 17. It should be noted that all imports acquired by firms in free zones (Regimes 10 and 11) are duty exempt and so is any commission charged on foreign exchange. As a result, there would be a net loss of import duties and foregone commission on foreign exchange for the country as a whole, worth approximately RD\$2,177 million, or 0.55 of one percentage point of GDP, under Phase I. An incremental loss of RD\$0.99 billion is expected between Phase I to Phase II of trade reform. Therefore, after Phase II the additional revenue loss is 0.99 billion or 0.25 percent of GDP. At this point, the cumulative revenue loss from the tax reform would be RD\$3,166 million, or 0.80 of one percentage of GDP.

**Table 17**  
**Tariff Restructure and Potential Government Revenues for**  
**Non-Excisable Commodities in all Regimes**  
**Excluding all Resolutions in 2002**  
**(millions of RD pesos)**

Regimes	Import at CIF Value	Import Duties	Phase I		Phase II	
			Import Duties	Gains	Import Duties	Gains
1	75,907.5	6,074.1	7,594.6	1,520.5	6,646.6	572.5
2	787.1	52.1	65.9	13.8	64.1	12.0
3	587.8	47.9	57.3	9.4	52.9	5.0
4	57.3	6.9	7.6	0.7	6.6	-0.3
5	0	0	0	0	0	0
6	773.5	131.5	133.3	1.8	104.0	-27.5
7	99.7	15.8	16.4	0.6	13.0	-2.8
8	24.4	3.6	3.8	0.2	3.5	-0.1
9	0.2	0	0	0	0	0
10	949.0	0	0	0	0	0
11	27,553.3	0	0	0	0	0
12	0.5	0	0	0	0	0
13	143.5	20.4	21.8	1.4	21.5	1.1
14	29.4	1.6	2.1	0.5	2.0	0.4
15	12.0	3.0	2.4	(0.6)	1.8	(1.2)
<b>Total</b>	<b>106,925.2</b>	<b>6,356.9</b>	<b>7,905.2</b>	<b>1,548.3</b>	<b>6,916.0</b>	<b>559.1</b>
4.75% Foreign Exchange Commission		3,725.1	0	(3,725.1)	0	(3,725.1)
<b>Grand Total</b>		<b>10,082.0</b>	<b>7,905.2</b>	<b>(2,176.8)</b>	<b>6,916.0</b>	<b>(3,166)</b>
<b>Total as Percentage of GDP</b>		<b>2.56</b>	<b>2.01</b>	<b>(0.55)</b>	<b>1.76</b>	<b>(0.80)</b>

To this point we have implicitly made the assumption that the elasticities of demand for all the imported items are equal to zero. This assumption is clearly not realistic. Hence, we carried out a second set of estimations of the revenue changes for Phase I and Phase II reforms. In these estimates we make a simplifying assumption that the price elasticity of demand for each imported commodity is equal to  $-1$ . The revenue impacts are estimated by first computing a change in the quantity demanded of imports caused by the increase or decrease in the new rate taking into consideration the removal of the 4.75 percent commission on foreign exchange. The new tariff revenue for each item is then calculated by multiplying the new quantity of import for the commodity by the new tariff rate. The results of the estimation that includes the behavioral response for Phase I and Phase II tariff reforms are presented in Table 18.

The behavioral response to changes in the tariff rates proposed in Phase I of the tariff reform is estimated to result in total tariff revenues equal to RD\$8,119.6 million, which is greater than RD\$7,905.2 million revenue previously estimated for Phase I reform without the behavioral

response. This is an increase of RD\$214 million in year 2002, or 0.05 of one percentage point of GDP. A similar result was found for Phase II of the tariff reform. The behavioral response raised the total tax revenues by RD\$298 million, or 0.07 of one percentage point of GDP, than the revenues raised under the reform without considering the behavioral response.

**Table 18**  
**Tariff Restructure and Potential Government Revenues**  
**for Non-Excisable Commodities, Inclusive of Behavioral Responses, 2002**  
**(millions of RD pesos)**

Regimes	Phase I			Phase II		
	No Behavioral Response	With Behavioral Response	Net Change due to Behavioral Response	No Behavioral Response	With Behavioral Response	Net Change due to Behavioral Response
1	7,594.6	7,793	204.7	6,646.6	6,931.1	284.5
2	65.9	67.6	1.7	64.1	65.9	1.8
3	57.3	58.8	1.5	52.9	54.8	1.9
4	7.6	7.8	0.2	6.6	6.9	0.3
5	0	0	0	0	0	0
6	133.3	138.1	4.8	104.0	111.2	7.2
7	16.4	16.9	0.5	13.0	13.8	0.8
8	3.8	3.9	0.1	3.5	3.6	0.1
9	0	0	0	0	0	0
10	0	0	0	0	0	0
11	0	0	0	0	0	0
12	0	0	0	0	0	0
13	21.8	22.4	0.6	21.5	22.1	0.6
14	2.1	2.2	0.1	2.0	2.1	0.1
15	2.4	2.6	0.2	1.8	2.0	0.2
<b>Total</b>	<b>7,905.2</b>	<b>8,119.6</b>	<b>214.4</b>	<b>6,916.0</b>	<b>7,213.5</b>	<b>297.5</b>
<b>Total as Percentage of GDP</b>	<b>2.01</b>	<b>2.06</b>	<b>0.05</b>	<b>1.76</b>	<b>1.83</b>	<b>0.07</b>

In short, the introduction of behavioral response to the removal of the 4.75 percent commission of foreign exchange and to the changes in the tariff rates, would lead to a loss of tariff revenues by one half of one percentage point of GDP under Phase I, and to an additional one quarter of one percentage point of GDP under Phase II.<sup>37</sup>

The implementation of Phase III would lead to the removal of all the tariff rates. This step will an additional cutback of RD\$7,213.5 million from the tariff duty collection, including the estimated behavior responses (Table 18). It is essential to look for alternative revenue

<sup>37</sup> Under the proposed Phase I reform with behavioral response, the total amount of import duties plus the 4.75% commission on foreign exchange would have decreased from 2.56 percent of GDP to 2.06 percent of GDP. For Phase II with behavioral response, it would decrease from 2.56 percent of GDP to 1.83 percent of GDP.

measures to fill the revenue gap caused by the reduction in tariff rates. As international practice suggests, a reliable source of revenue in developing countries is a combination of domestic indirect taxes, especially VAT. Given that the ITBIS system in the Dominican Republic has room for further improvement, the ITBIS option stands out as the prime candidate to generate additional revenue. It is estimated that 4 percentage points increase in the rate of ITBIS to 16 percent would be sufficient to cover the revenue loss from the trade reform measures of Phase III and Phase IV. Table 24 in Section 7 outlines the procedure for the estimations based on the net revenue impact from all the recommendations.

Phase IV takes another look at the potential of using ITBIS as a revenue source instead of the trade taxes. The rate of foreign exchange commission was recently raised from 4.75 to 10 percent, and while the loss of 4.75 percent of foreign exchange commission was already included in Phase I, it is important to analyze the implications of yet additional loss of 5.25 percentage points of the commission in Phase IV. The estimated amount of this loss is RD\$4,699.89 million, combining both the excisable goods of Regime 1 and non-excisable, non-exempt by resolutions, goods of Regime 1 and other regimes currently paying the foreign exchange commission.

Thus, the additional loss of foreign exchange commission on excisable goods of Regime 1 is estimated as the difference between the existing commission collection of RD\$530.9 million with the 4.75 percent rate (Table 20), and the amount of commission of RD\$1,113.58 million, which would have been raised, with the 10 percent rate applied on the CIF volume of RD\$11,135.78 million (Table 20).

Similarly, the additional loss of foreign exchange commission on non-excisable, non-exempt by resolutions, goods of Regime 1 and other regimes currently paying the foreign exchange commission, can be estimated from Table 17. The CIF volume of non-excisable, non-exempt by resolutions, goods of all regimes is recorded as RD\$106,925.2 million, while only RD\$3,725.1 million was collected in terms of foreign exchange commission with a 4.75 percent rate. Then, the CIF volume subject to foreign exchange commission can be found by dividing the amount collected with the statutory rate of 4.75 percent, resulting in a figure of RD\$78,423.16 million. This difference between the actual CIF and the volume subject to commission is due to the fact that some regimes are exempt from the foreign exchange commission, the biggest exemption being for the free zones. Using the import volumes of RD\$78,423.16 million as a base for a 10 percent commission, gives us an estimate of RD\$7,842.32 million that would have been collected in year 2002 from all the regimes subject to foreign exchange commission, excluding excisable goods and exemptions by resolutions. The difference between the actual collection at 4.75 percent and estimated amount at 10 percent is RD\$4,117.22 million in 2002 prices.

The combined loss of foreign exchange commission in Phase IV is, therefore, a sum of the estimated loss from the excisable goods of Regime 1 and the estimated loss from all the regimes subject to foreign exchange commission, excluding excisable goods and exemptions by resolutions. The resulting amount of revenue cutback from the foreign exchange commission is RD\$4,699.89 million. Table 24 in Section 7 looks at the possibility of financing the resulting revenue loss by raising the rate of ITBIS.

### 6.3 Tariff and Excise Tax Reform on Excisable Goods

Excisable commodities are now virtually all subject to either a 14 or a 20 percent import duty as well as a 4.75 percent commission (10 percent recently) charged on the foreign exchange used to purchase imported goods.<sup>38</sup> In addition, the excise taxes applied on imports vary from a 10 percent rate on ovens other than microwave to 60 percent rate on revolvers and pistols. It is reasonable that excisable commodities also be subject to a normal import duty under the initial structure of the reform system. These goods are mainly consumer goods. We conducted our revenue analysis by proposing that after Phase I of the reform all excisable goods will be subject to a flat import duty rate of 10 percent. On top of it, there would be an excise levy structured in such way that the total tax burden on each commodity including the 4.75 percentage point reduction in the commission on foreign exchange remains unchanged from the current system. These rates are presented in Table 19, column 4.

**Table 19**  
**Current and Proposed Excise Tax Rates on Goods and Services**

Harmonization Code (1)	Description (2)	Excise Tax Rates (percent)			
		Current Rates (3)	Reformed Rates, Phase I (4)	Reformed Rates, Phase III (5)	Reformed Rates, Phase IV (6)
1604.30.00	Caviar and caviar substitutes	50	67	84	89
2203.00.00	Beer made from malt	25	40	54	59
2204.10.00; 2204.21.00; 2204.29.00; 2205.10.00; 2205.90.00	Sparkling wine, vermouth and other wine of fresh grapes	35	51	66	71
2204.30.00	Sparkling wine, other grape must	35	44	58	63
2206.00.00	Other fermented beverages	30	46	60	65
2207.10.00; 2207.20.00	Ethyl alcohol and other sprints	45	54	70	74
2208.20.91; 2208.20.92; 2208.30.90	Whiskies and spirits obtained by distilling grape wine	45	62	78	83
2208.40.00	Rum and tafia	35	51	66	71
2208.50.00; 2208.60.00	Gin and Vodka	45	62	78	83
2208.70.00; 2208.70.20; 2208.70.90	Liqueurs and cordials	35	51	66	71
2208.90.10	Undenatured ethyl alcohol	45	54	70	74
2208.90.41; 2208.90.49; 2208.90.90	Undenatured ethyl alcohol	45	62	78	83
2402.10.00	Cigars	25	40	54	59
2402.20.10; 2402.20.20; 2402.90.00	Cigarettes	50	67	84	89
3303.00.00	Perfumes and toilet waters	30	46	60	0

<sup>38</sup> Only one item is subject to 3 percent rate. This item is called parabolic aerial reflector dishes of a diameter not exceeding 129cm, other. The Harmonization Code is 8529.10.91.

Harmonization Code (1)	Description (2)	Excise Tax Rates (percent)			
		Current Rates (3)	Reformed Rates, Phase I (4)	Reformed Rates, Phase III (5)	Reformed Rates, Phase IV (6)
3922.10.11	Baths and similar ware	40	57	72	0
5701.10.00; 5701.90.00	Carpets	45	62	78	0
5702.10.00; 5702.20.00; 5702.31.00; 5702.32.00; 5702.39.10; 5702.39.90; 5702.41.00; 5702.42.00; 5702.49.10; 5702.49.90; 5702.51.00; 5702.52.00; 5702.59.00; 5702.92.00; 5702.99.00	Rugs	30	46	60	0
5703.10.00; 5703.20.00; 5703.30.00; 5703.90.00; 5805.00.00	Carpets and other textile floor coverings	30	46	60	0
7113.11.00; 7113.19.10; 7113.19.90; 7113.20.00; 7114.11.00; 7114.19.10; 7114.19.90; 7114.20.00; 7116.10.00; 7116.20.00; 7117.11.00; 7117.19.00; 7117.90.00	Articles of jewelry and parts thereof; articles of natural or cultured pearls; imitation jewelry	30	46	60	0
7324.21.00; 7324.29.00	Sanitary ware and parts thereof	40	57	72	0
7418.20.00; 7615.20.00	Table, kitchen or household articles	40	57	72	0
8415.10.00; 8415.20.00; 8415.81.00; 8415.82.00; 8415.83.00	Air conditioning machines	30	46	60	0
8415.90.00	Air conditioning machines	30	39	52	0
8479.60.00	Machines and mechanical appliances	30	46	60	0
8509.10.00; 8509.20.00; 8509.30.00; 8509.40.90; 8509.80.00	Electro-mechanical domestic appliances	20	35	48	0
8516.10.00	Electric instantaneous or storage water heaters	40	57	72	0
8516.50.00; 8516.60.10	Microwave ovens	15	29	42	0
8516.60.20	Other ovens	10	24	36	0
8516.60.30	Other ovens	25	40	54	0
8516.71.00	Coffee or tea makers	25	40	54	0
8516.72.00	Toasters	15	29	42	0
8516.79.00	Electric heating resistors	15	29	42	0
8517.19.10	Telephone sets	25	40	54	0
8519.10.00	Coin- or disc-operated record-players	15	29	42	0
8519.21.00; 8519.29.00; 8519.31.00; 8519.39.00; 8519.40.00; 8519.92.00; 8519.93.00; 8519.99.10; 8519.99.90; 8520.32.00; 8520.33.00; 8520.90.00	Turntables, record-players, other sound reproducing apparatus; audio-video equipment for lecturing	15	29	42	0
8521.10.00; 8521.90.00;	Video recording, reception	25	40	54	0

Harmonization Code (1)	Description (2)	Excise Tax Rates (percent)			
		Current Rates (3)	Reformed Rates, Phase I (4)	Reformed Rates, Phase III (5)	Reformed Rates, Phase IV (6)
8525.40.00; 8527.13.10; 8527.21.10; 8527.31.10	apparatus				
8528.12.00	Reception appliance for Television	15	29	42	0
8528.21.00	Video monitors	25	40	54	0
8529.10.00; 8529.10.20	Parabolic aerial reflector dishes	15	29	42	0
8529.10.91	Parabolic aerial reflector dishes – small size	15	12	42	0
8529.90.10	Cabinets for reception apparatus for TV	15	29	42	0
8529.90.90	Cabinets for reflection apparatus for TV: other	15	23	35	0
8703.10.00; 8703.21.92; 8703.21.99; 8703.22.91; 8703.22.92; 8703.22.99; 8703.23.16; 8703.23.17; 8703.23.19; 8703.23.91; 8703.23.92; 8703.23.99; 8703.24.91; 8703.24.92; 8703.24.99; 8703.31.91; 8703.32.91; 8703.33.91; 8703.33.92; 8703.33.99; 8703.90.00	Motor cars and other motor vehicles	Variable from 0 to 80 percent of CIF value	20	32	37
8903.91.10; 8903.99.20	Yachts and other vessels	45	62	78	83
9101.11.00; 9101.19.00; 9101.21.00; 9101.29.00; 9101.91.00; 9101.99.00	Wrist-watches	30	46	60	0
9302.00.10; 9302.00.00; 9302.00.90	Revolvers and pistols	60	78	96	101
<b>Services</b>					
	Telecommunication services	2	12	12	12
	Airline tickets	0	10	10	10
	Insurance	0	10	10	10

With the proposed structure of excise rates, the imports generate a total revenue of RD\$5,967 million, consisting of RD\$1,118 million of import duties, RD\$3,012 million of excise taxes, and RD\$1,837 million of the ITBIS for Regime 1 without taking into consideration all resolutions. The proposed rationalization of the import duties and excise taxes was designed in such way that the consumer prices of the excisable goods inclusive of the ITBIS would remain unchanged after the reform.<sup>39</sup> With the exception of vehicles, the total revenues collected for

<sup>39</sup> This is based on the assumption that the 4.75 percent commission on foreign exchange and indirect taxes are fully shifted forward to final consumers. Since October 2003, the rate of commission was set at 10 percent as a temporary measure. A probable loss of the remaining 5.25 percent of the commission, assuming that the 5.25 percent rate is place during Phase I and Phase II, will have to be either incorporated into higher excise rate or financed by additional revenue source.

each excisable good would be exactly the same amount of the total revenues under the current system. This included the commission on foreign exchange, import duties and excise tax as shown in Table 20.

In the case of vehicles, we propose to impose a 20 percent flat excise tax rate on top of a general 10 percent import duty rate. This 20 percent excise tax would replace the revenue lost from the 10 percent reduction of the import duties, the elimination of the 4.75 percent foreign exchange commission, and the revenues collected by the existing system of excise taxes. The simulation results show that the proposal also generates an additional RD\$550 million including the 4.75 percent commission on foreign exchange (-RD\$429 million), import duties (-RD\$904 million), excises (RD\$1,778 million) and the ITBIS (RD\$105 million).<sup>40</sup> This is equivalent to 0.14 of one percentage of GDP.

Since the excise taxes are levied on both domestic and imported goods on an equal basis, there would be no distortions among similar types of goods consumed within the country. Therefore, as the excise tax rates are adjusted upward for imported goods as proposed, the excise tax for domestically produced goods should be adjusted up to the same levels. However, since the retail prices of specific imported excisable goods to consumers remain unchanged, the domestically produced goods would not likely be changed much because of the competitive market forces for the similar goods. In other words, although the excise rates may be adjusted upward at the same rates as imported goods, the previously mark-up percentage adjustments for the tax base of specific domestic excisable goods would have to be revised as well.

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<sup>40</sup> Estimates made using a different data files obtained from the Customs, the simulations show a higher total tax revenue gain of at RD\$667 million as shown in Appendix D. The results are also presented by regime.

**Table 20**  
**Revenue Impact of Reform on Major Imported Excisable Commodities**  
**in Regime 1 Excluding all Resolutions, 2002**  
**(thousands of RD pesos)**

	<b>Import at CIF Value</b>	<b>4.75% Commission on Foreign Exchange</b>	<b>Import Duty</b>	<b>Excise Tax</b>	<b>ITBIS</b>	<b>Total Taxes and 4.75% Commission</b>
<b>Current System</b>						
Caviar	380	18	76	228	82	404
Alcoholic Beverages:						
Beer	153,652	7,298	30,730	46,096	27,657	111,781
Wine	191,222	9,083	38,164	79,422	37,059	163,728
Spirits	387,247	18,394	75,459	204,494	80,064	378,411
Tobacco:						
Cigarettes/Cigars	1,080	51	216	325	194	786
Others	8,521	405	1,704	5,113	1,841	9,063
Perfumes	67,852	3,223	13,570	24,427	12,702	53,922
Bath	5,540	263	1,108	2,659	1,117	5,147
Rugs/Carpets	23,626	1,122	4,725	8,689	4,445	18,981
Jewelry	38,228	1,816	7,646	13,762	7,156	30,381
Sanitary & Kitchen Wares	3,905	185	781	1,874	787	3,627
Air Conditioning	317,926	15,101	59,272	113,159	58,843	246,375
Electric, Microwaves, Telephones, Audio-Video	876,699	41,643	170,314	184,977	147,839	544,773
Vehicles	8,994,975	429,214	1,807,215	210,605	1,326,468	3,773,502
Yachts	5,596	266	1,119	3,022	1,168	5,575
Watches	379	18	76	136	71	301
Revolvers/Pistols	58,949	2,800	11,790	42,443	13,582	70,615
<b>Total</b>	<b>11,135,777</b>	<b>530,902</b>	<b>2,223,966</b>	<b>941,452</b>	<b>1,721,076</b>	<b>5,417,396</b>
<b>Proposed System</b>						
Caviar	380	0	38	282	84	404
Alcoholic Beverages:						
Beer	153,652	0	15,365	67,977	28,439	111,781
Wine	191,222	0	19,122	106,594	38,033	163,749
Spirits	387,247	0	38,725	257,652	82,035	378,412
Tobacco:						
Cigarettes/Cigars	1,080	0	108	479	200	786
Others	8,521	0	852	6,326	1,884	9,062
Perfumes	67,852	0	6,785	34,090	13,047	53,922
Bath	5,540	0	554	3,448	1,145	5,147
Rugs/Carpets	23,626	0	2,363	12,053	4,565	18,981
Jewelry	38,228	0	3,823	19,206	7,351	30,380
Sanitary & Kitchen Wares	3,905	0	390	2,430	807	3,627
Air Conditioning	317,926	0	31,793	154,122	60,461	246,376
Electric, Microwaves, Telephones, Audio-Video	876,699	0	87,670	304,803	152,301	544,774
Vehicles	8,994,975	0	903,608	1,987,937	1,431,315	4,322,860
Yachts	5,596	0	560	3,819	1,197	5,576
Watches	379	0	38	190	73	301
Revolvers/Pistols	58,949	0	5,895	50,838	13,882	70,615
<b>Total</b>	<b>11,135,777</b>	<b>0</b>	<b>1,117,688</b>	<b>3,012,247</b>	<b>1,836,818</b>	<b>5,966,753</b>

With the above assumptions, we calculate the percentage increase in proposed excise tax rates over the current rates. Some of these increases are greater than the corresponding mark-up percentage for the purpose of calculating the excise tax for domestic goods. For the purpose of this analysis, we would anticipate removal of the mark-up percentage adjustment for computing excise tax liabilities. As a result, this would raise tax revenues from RD\$4,235 million to RD\$5,237 million as shown in Table 21. Thus, the net gain of tax revenues would be RD\$1,002 million in 2002 prices or a quarter of one percentage point of GDP.<sup>41</sup>

**Table 21**  
**Potential Gain in Domestically Produced Excisable Goods**  
**(thousands of RD pesos)**

Categories	Quantities Sold	Value of Sales	Excise Tax Revenues		
			Current	Proposed	Gains
Wine, Liquor	796,804	227,911.0	103,699.5	116,234.6	12,535.1
Brandy and Cognac	3,339,194	446,185.8	259,774.8	276,635.2	16,860.4
Rum and Other Drinks	4,687,623	1,222,384.7	520,550.3	612,416.2	91,865.9
Fermented Beverages	297,639	62,324.5	24,306.5	28,669.3	4,362.7
Beer	31,454,152	7,504,977.8	2,252,093.3	3,001,991.1	749,897.8
Other Beverages	116,009	2,256.4	1,320.0	1,037.9	(282.1)
Cigars	1,474,741	27,007.6	8,102.3	10,803.1	2,700.8
Cigarettes	15,230,430	1,774,865.1	1,064,919.1	1,189,159.7	124,240.6
Others			36.1	36.1	--
<b>Total</b>	<b>--</b>	<b>11,267,912.9</b>	<b>4,234,801.9</b>	<b>5,236,983.2</b>	<b>1,002,181.3</b>

With this reform, the system would be much simpler and transparent. Of course, the excise tax on various commodities can be converted to a unit tax rate for administrative simplicity and should be adjusted from time to time according to the movement of a price index in order to maintain the same real value of tax collections.

<sup>41</sup> If the Dominican Republic decided to eliminate its import tariffs completely, it could adjust its excise taxes further on these same excisable commodities to compensate for the revenue lost from the elimination of tariffs. As a consequence, more revenues would be raised from the increased excise rates on domestically produced excisable goods.

## 6.4 Reform on Resolutions

As mentioned earlier, there are currently 20 resolutions in place to provide full or partial import duty and other tax exemptions in the Dominican Republic. These resolutions accounted for approximately 13 percent of the total value of imports other than those going to the free zones.<sup>42</sup> If all resolutions were removed, the government would have collected additional import duties of RD\$1,284 million, excise taxes of RD\$20 million, and ITBIS of RD\$1,499 million in 2002. Details for each resolution and the type of taxes can be found in Table 22.

The removal of all resolutions, however, is impossible. For example, Resolution 18 regarding imports under the free trade agreements with Caribbean or other countries would not likely be altered. The imports for the use by the government of a foreign country or by diplomats may be considered reasonable for duty exemption because of either the reciprocal agreements between countries or because it is a common international practice. In the case of Resolution 13 for returned Dominicans, the vehicles, furniture, and other goods they bring home should not be subject to import duty as is the common practice internationally. Business samples and items used for medical laboratories will likely continue to be duty exempted. Petroleum products imported for use in the hydrocarbons sector will continue to be exempt under the import duty, but subject to excise tax. For other categories such as government departments and cooperatives for public servants, however, they should be treated in the same manner as other purchasers of imported goods in order to prevent over consumption or abuse of the system. The concerns of NGO, education, promotion for agriculture, textile manufacturing, hotel-tourism, etc. can be better addressed elsewhere through expenditure programs in order to minimize tax distortions.

If the resolutions made for government departments (Resolutions 1 and 11), institutions for NGOs (Resolution 2), education (Resolution 10), government employees (Resolution 6), promotion for hotel tourism (Resolution 5), agriculture (Resolution 8), textile manufacturing (Resolution 9) and the office of Director of Communication (Resolution 12) were removed, the potential import duties amounts to RD\$978 million or a quarter of one percentage point of GDP in 2002. For excise taxes alone, the increase is only RD\$9 million. In the case of ITBIS, the increase in taxes is substantial, as much as RD\$1,379 million.

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<sup>42</sup> This is the ratio of (RD\$14,864 million – RD\$1,047 million) to RD\$106,394 million, the total imports in the nation other than those either imported from Caribbean and other countries with free trade agreements or those entering the free zone areas.

**Table 22**  
**Potential Revenue Gains in Tax Revenues if Resolutions were Repealed**  
**(thousands of RD pesos)**

Resolutions	Import at CIF Value	Current System			Removal of Resolutions		
		Import Duty	Excise Tax	ITBIS	Import Duty	Excise Tax	ITBIS
1. Government Departments *	174,215	3,393	282	2,591	19,833	1,723	22,841
2. NGO*	332,560	2,904	1,056	5,946	31,584	2,560	41,086
4. Embassies	5,230	130	18	96	966	103	718
5. Tourism – Hotel Promotion*	1,060	0	0	0	108	0	140
6. Cooperatives for Government Employees*	5,952	51	0	206	794	48	815
7. Diplomats	18,885	419	20	304	3,545	450	2,732
8. Promotion for Agriculture*	56,881	815	0	246	1,190	0	6,600
9. Promotion for Textile Manufacturer*	522	0	0	0	45	0	68
10. Educational Bodies*	180,594	17	0	12	21,080	1,470	20,989
11. Entregas Provisionales*	7,630,585	9,606	211	7,389	650,442	17,356	943,804
12. Oficio del Director*	3,507,167	61,715	46,531	64,814	331,343	34,308	423,543
13. Returned Dominicans	125,297	246	35	187	14,360	1,879	14,861
14. Muestras	151,709	1,814	0	1,576	12,095	0	12,691
15. Medical Laboratory	243,013	1,978	0	1,656	15,998	0	24,015
16. Mudanzas	174,905	617	56	571	24,151	3,922	22,196
17. Vehicles for Returned Dominicans	200,414	7,639	1,003	14,845	39,239	5,050	29,122
18. Free Trade Agreements	1,046,750	1,551	209	100,061	176,360	246	128,341
19. Ley de Hidrocarburo	1,008,577	89	26	71	30,399	20	4,996
20. Formulario 22	59	0	0	0	2	0	7
<b>Total</b>	<b>14,864,376</b>	<b>92,985</b>	<b>49,448</b>	<b>200,570</b>	<b>1,376,531</b>	<b>69,135</b>	<b>1,699,568</b>

Sources: Simulations were conducted using detailed micro data by harmonization code, and associated specific tax rates within each resolution. The data was obtained from the Customs Department, Ministry of Finance, Dominican Republic.

Note: \* The star indicates the proposed removal of resolutions.

If the imports were taxed according to the proposed rates, the estimated gains in import duty revenues by resolution are presented in Table 23. Suppose that only resolutions 1, 2, 5, 6, 8, 9, 10, 11 and 12 were removed, the potential gains would have been RD\$1,021 million for Phase I and RD\$927 million for Phase II based on the respective proposed import duty rates. If the exemption of other taxes such as excise tax and ITBIS associated with the proposed removal of certain resolutions is also removed, there will be a further gain in the revenues.

**Table 23**  
**Gains in Import Duties under Proposed Rates**  
**(thousands of RD pesos)**

Resolutions	Imports at CIF Value	Import Duties	Phase I		Phase II	
			Import Duties	Revenue Gains	Import Duties	Revenue Gains
1. Government Departments *	174,215	3,393	14,359	10,966	13,848	10,455
2. NGO*	332,560	2,904	28,899	25,995	26,071	23,167
4. Embassies	5,230	130	583	453	542	412
5. Tourism – Hotel Promotion*	1,060	0	122	122	122	122
6. Cooperatives for Government Employees*	5,952	51	624	573	553	502
7. Diplomats	18,885	419	1,984	1,565	1,908	1,489
8. Promotion for Agriculture*	56,881	815	3,545	2,730	3,329	2,514
9. Promotion for Textile Manufacturer*	522	0	55	55	44	44
10. Educational Bodies*	180,594	17	16,102	16,085	14,662	14,645
11. Entregas Provisionales*	7,630,585	9,606	692,558	682,952	635,118	625,512
12. Oficio del Director*	3,507,167	61,715	343,557	281,842	311,627	249,912
13. Returned Dominicans	125,297	246	13,995	13,749	11,901	11,655
14. Muestras	151,709	1,814	14,305	12,491	12,453	10,639
15. Medical Laboratory	243,013	1,978	3,963	1,985	6,851	4,873
16. Mudanzas	174,905	617	19,870	19,253	17,180	16,563
17. Vehicles for Returned Dominicans	200,414	7,639	20,977	13,338	20,418	12,779
18. Free Trade Agreements	1,046,750	1,551	14,684	13,133	11,427	9,876
19. Ley de Hidrocarburo	1,008,577	89	50,474	50,385	50,471	50,382
20. Formulario 22	59	0	3	3	3	3
<b>Total</b>	<b>14,864,376</b>	<b>92,985</b>	<b>1,243,660</b>	<b>1,150,675</b>	<b>1,138,529</b>	<b>1,045,544</b>

In addition to the proposed reform, the government revenues can also be increased if the Customs and tax administrations were to improve their efficiency. However, the revenue implications of such improvements are difficult to estimate.

## 7. Summary of Total Revenue Implications by Stages

### 7.1 Reforms of Domestic Taxes and Non-Excise Tradable Goods

The package of proposed measures could be summarized as presented in Table 24 by first separating the revenue raising reforms from the measures reducing revenue collection. The revenue raising measures include the recommendations for individual and corporate income tax, ITBIS reform, restructuring the taxation of excisable goods, and removal of certain

resolutions for imported goods. The aggregate estimated amount of additional revenue is RD\$9.60 billion in 2002 prices, or 2.44 percent of GDP before we consider the revenue impact of raising the rate of ITBIS. Quantification of certain proposed measures such as modernization and strengthening of the Customs and tax administration is not included into this figure.

The liberalization of trade with the Americas, and gradual reduction of import duty tariff rates in line with the WTO demands presents a major challenge for revenue collection. Thus, Phase I reform is going to lower many of the tariff rates, to reduce the foreign exchange commission, and to result in a cost in terms of revenues of loss of RD\$1.97 billion in 2002 prices,<sup>43</sup> or 0.50 percent of GDP.

After the implementation of Phase II of customs reforms, the additional cost of tariff duty collection will be RD\$0.91 billion in 2002 prices, or 0.23 percent of GDP. At that time, the total impact of both Phase I and Phase II losses of tariff collection and foreign exchange commission will amount to RD\$2.88 billion in 2002 prices, or 0.73 percent of GDP.

An eventual removal of all tariff duties on non-excisable imports in Phase III will imply a permanent loss of an additional RD\$7.21 billion in 2002 prices, or 1.83 percent of GDP. Thus, the total impact of the import tariff reforms after Phase I, Phase II and Phase III is estimated to be RD\$10.09 billion in 2002 prices, or 2.57 percent of GDP.

## **7.2 Reform of Selective Taxes on Consumption (Excise Taxes)**

At the end of Phase III of the measures outlined above, there will be a total of about 150 harmonized code items subject to excise tax plus excise taxes on telephone services, insurance, and air travel. This number of items is rather large for a modern tax system. In the case of a number of items, the purpose of the tax is entirely for revenue purposes, and the choice of commodity is difficult to justify on economic or tax policy grounds, e.g. air conditioners, microwave stoves.

A more appropriate set would include less than 20 types of commodities and services. It is recommended that at the time when the last 5.25 percentage points of the foreign exchange commission is being eliminated the government should also take steps to eliminate the excise tax from a number of commodities. The revenue loss would also be made up by raising the rate of ITBIS. A more suitable list of excisable goods would include all alcoholic beverages, tobacco products, petroleum products, electricity, communication, insurance, airline tickets, vehicles, guns and perhaps a few other items whose consumption was thought desirable to contain.

Phase IV of the tariff reforms is devised to estimate the revenue implications in a situation when the rest of the foreign exchange commission is eliminated and the number of selected taxes on consumption are reduced. The assumption is that the current “temporary” 10 percent rate of the commission is reduced by 4.75 percent after Phase I, and kept at 5.25 percent level

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<sup>43</sup> The figure RD\$1.97 billion is obtained from the import duties under the proposed reform (RD\$8.12 billion) less the import duties that were replaced (RD\$6.36 billion) and less foreign exchange commission forgone (RD\$3.73 billion).

throughout Phase II and Phase III. However, at some point this commission must be replaced by another tax and the amount of this loss must be quantified. Thus, the additional loss of foreign exchange commission during Phase IV is estimated as RD\$4.70 billion in 2002 prices, or 1.19 percent of GDP. The revenue cost of reducing the number of excise taxes would be RD\$0.81 billion or 0.21 percentage of GDP. The total net loss of proposed tariff measures after Phase I, Phase II, Phase III and Phase IV is then equal to RD\$15.59 billion in 2002 prices, or 3.97 percent of GDP. The implied set of excise tax rates that would maintain the same total tax rate on the final set of excisable goods in currently levied by the combination of foreign exchange commission plus import duties and excise taxes are reported in Table 19, Column 6.

### **7.3 Aggregate Revenue Impact by Phases**

The total net revenue impact of the proposed measures is defined as the sum of the revenue raising reforms and tariff duty reforms reducing revenue collection up to a particular point in time. For example, taking into account all the proposed measures, the total effect after Phase I of trade liberalization is estimated to be a revenue gain of RD\$7.63 billion in 2002 prices (=RD\$9.60 – RD\$1.97 billion), or 1.94 percent of GDP. When the next round of tariff rate reduction is undertaken in Phase II, the additional revenue impact is a loss of RD\$0.91 billion in 2002 prices, or 0.23 percent of GDP. But the total effect of the reforms remains positive after Phase II, estimated to be RD\$6.72 billion in 2002 prices, or 1.71 percent of GDP. A substantial loss of tariff revenue is expected after implementation of Phase III, when all the tariff duties on non-excisable goods are removed, at a cost of RD\$7.21 billion in 2002 prices, or 1.83 percent of GDP. The total revenue impact after Phase III is estimated to be a loss of RD\$0.49 billion in 2002 prices, or 0.12 percent of GDP. Phase IV of trade reform will reduce the foreign exchange commissions by RD\$4.70 billion and excise tax revenues by 0.81 billion in 2002 prices, or 1.40 percent of GDP. The resulting net cumulative impact of all reforms after Phase I, Phase II, Phase III and Phase IV is RD\$6.00 billion in 2002 prices, or 1.53 percent of GDP.

In summary, the main recommendations and their estimated revenue implications can be summarized in Table 24.

**Table 24**  
**Summary of Tax Proposals and Revenue Implications**

Major Tax Systems	Revenue Raising Measures	Impact on Annual Revenue in 2002 Prices, RD\$ billions	Impact on Annual Revenue in % of GDP
Individual Income Tax	<ul style="list-style-type: none"> <li>▪ Impose a 15% tax rate on gross earnings of professionals</li> <li>▪ Raise the tax rates of 0.75 to 1.25% on receipts for small businesses to 1.5%</li> <li>▪ Impose a rate of 10% on interest earned by individuals from deposit-taking institutions</li> <li>▪ Strengthen tax administration</li> </ul>	<ul style="list-style-type: none"> <li>▪ Positive effect<sup>1</sup></li> <li>▪ Raise RD\$1.27 million<sup>2</sup></li> <li>▪ Raise RD\$1.53 billion<sup>3</sup></li> <li>▪ Positive effect<sup>4</sup></li> </ul>	<ul style="list-style-type: none"> <li>▪ Positive effect</li> <li>▪ Raise 0.0003% of GDP</li> <li>▪ Raise 0.39% of GDP</li> <li>▪ Positive effect</li> </ul>
Corporate Income Tax	<ul style="list-style-type: none"> <li>▪ Adjust income up by the rate of inflation times the amount of net financial debt held by corporation while allowing for the full deduction of interest expenses and depreciation of assets with inflation adjustment</li> </ul>	<ul style="list-style-type: none"> <li>▪ Raise RD\$1.20 billion<sup>5</sup></li> </ul>	<ul style="list-style-type: none"> <li>▪ Raise 0.31% of GDP</li> </ul>
ITBIS (VAT)	<ul style="list-style-type: none"> <li>▪ Expand tax base</li> <li>▪ Keep the exempt list to basic grocery, petroleum products, essential medical drugs, electricity, deposit-taking and other financial services, and some social services</li> <li>▪ Provide immediate refunds of excess input tax credits especially for export-oriented firms</li> <li>▪ Strengthen Customs and the tax administration</li> </ul>	<ul style="list-style-type: none"> <li>▪ Raise RD\$2.24 billion<sup>6</sup></li> </ul>	<ul style="list-style-type: none"> <li>▪ Raise 0.57% of GDP</li> </ul>
Tariff Reform on Imported Excisable Goods	<ul style="list-style-type: none"> <li>▪ Lower all import tariffs on excisable goods to 10% and adjust excise tax rates on each of the excisable goods with the exception of vehicles in order to keep retail prices unchanged</li> <li>▪ For vehicles, impose a flat excise tax rate of 20% on top of the general 10% import duty</li> </ul>	<ul style="list-style-type: none"> <li>▪ Revenue-neutral for excisable goods other than vehicles<sup>7</sup></li> <li>▪ Raise RD\$0.55 billion for vehicles<sup>8</sup></li> </ul>	<ul style="list-style-type: none"> <li>▪ Revenue-neutral for excisable goods other than vehicles</li> <li>▪ Raise 0.14% of GDP for vehicles</li> </ul>
Reform of Domestically Produced Excisable Goods	<ul style="list-style-type: none"> <li>▪ Adjust excise tax rates as the same as the above proposed rates for imported goods</li> <li>▪ Impose a 10% on the telecommunication service</li> <li>▪ Levy a 10% on airline tickets and insurance premiums, but exempting both under the ITBIS</li> </ul>	<ul style="list-style-type: none"> <li>▪ Raise RD\$1.00 billion<sup>9</sup></li> <li>▪ Raise RD\$1.91 billion for phone services<sup>10</sup></li> <li>▪ Raise RD\$0.25 billion for airline tickets and insurance services<sup>11</sup></li> </ul>	<ul style="list-style-type: none"> <li>▪ Raise 0.25% of GDP</li> <li>▪ Raise 0.48% of GDP for phone services</li> <li>▪ Raise 0.064% of GDP for airline tickets and insurance services</li> </ul>
Reform Resolutions	<ul style="list-style-type: none"> <li>▪ Remove import duty exemptions for Resolutions 1,2,5,6,8,9,10,11 and 12</li> </ul>	<ul style="list-style-type: none"> <li>▪ Raise RD\$0.98 billion<sup>12</sup></li> </ul>	<ul style="list-style-type: none"> <li>▪ Raise 0.25% of GDP</li> </ul>
Tax and Customs Administration	<ul style="list-style-type: none"> <li>▪ Establish a semi-autonomous revenue authority</li> <li>▪ Modernize tax administration</li> <li>▪ Improve and modernize the Customs Administration</li> <li>▪ Refund excess input tax credits under ITBIS</li> <li>▪ Make tax exempt system work for export-oriented firms</li> </ul>	<ul style="list-style-type: none"> <li>▪ Minimize leakage</li> <li>▪ Protect tax revenues</li> <li>▪ Provide taxpayer services</li> </ul>	<ul style="list-style-type: none"> <li>▪ Positive Effect<sup>13</sup></li> </ul>
	<b>Subtotal Revenue Raising Measures</b>	<ul style="list-style-type: none"> <li>▪ <b>Raise RD\$9.60 billion</b></li> </ul>	<ul style="list-style-type: none"> <li>▪ <b>Raise 2.44% of GDP</b></li> </ul>

**Table 24**  
**Summary of Tax Proposals and Revenue Implications**  
**(Continued)**

<b>Phases of Import Tariff Reform</b>	<b>Measures Reducing Revenue Collection Import Tariff Reform on Non-Excisable Goods</b>	<b>Impact on Annual Revenue in 2002 Prices, RD\$ billions</b>	<b>Impact on Annual Revenue in % of GDP</b>
Phase I	<ul style="list-style-type: none"> <li>▪ Remove 4.75% foreign exchange commission</li> <li>▪ Simplify import tariff structure for non-excisable goods to 4 rates (5, 10, 15 and 20%)</li> </ul>	<ul style="list-style-type: none"> <li>▪ Lose revenues by RD\$1.97 billion<sup>14</sup></li> </ul>	<ul style="list-style-type: none"> <li>▪ Lose revenues by 0.53% of GDP</li> </ul>
Phase II	<ul style="list-style-type: none"> <li>▪ Reduce the upper tariff rate to 15%, and have only to 3 rates (5, 10, and 15%)</li> </ul>	<ul style="list-style-type: none"> <li>▪ Lose revenues by RD\$0.91 billion<sup>15</sup> (Total net loss of RD\$2.88 billion)</li> </ul>	<ul style="list-style-type: none"> <li>▪ Lose revenues by 0.23% of GDP (Total net loss of 0.73% of GDP)</li> </ul>
Phase III	<ul style="list-style-type: none"> <li>▪ Remove all tariffs on non-excisable goods, have a single 0% rate</li> </ul>	<ul style="list-style-type: none"> <li>▪ Lose revenues by RD\$7.21 billion<sup>16</sup> (Total net loss of RD\$10.09 billion)</li> </ul>	<ul style="list-style-type: none"> <li>▪ Lose revenues by 1.83% of GDP (Total net loss of 2.57% of GDP)</li> </ul>
Phase IV	<ul style="list-style-type: none"> <li>▪ Remove an additional 5.25% foreign exchange commission</li> <li>▪ Reduction in number of selective taxes on consumption</li> </ul>	<ul style="list-style-type: none"> <li>▪ Lose revenues by RD\$5.51 billion<sup>17</sup> (Total net loss of RD\$15.59 billion)</li> </ul>	<ul style="list-style-type: none"> <li>▪ Lose revenues by 1.40% of GDP (Total net loss of 3.97% of GDP)</li> </ul>
<b>Total Impact of Proposed Measures as compared to no reform (Gains minus Losses)</b>	<p><b>After implementation of proposed recommendations:</b></p> <ul style="list-style-type: none"> <li>▪ <b>Phase I</b></li> <li>▪ <b>Phase II</b></li> <li>▪ <b>Phase III</b></li> <li>▪ <b>Phase IV</b></li> </ul>	<ul style="list-style-type: none"> <li>▪ <b>Total Revenue Gain of RD\$7.63 billion</b></li> <li>▪ <b>Total Revenue Gain of RD\$6.72 billion</b></li> <li>▪ <b>Total Revenue Loss of RD\$0.49 billion</b></li> <li>▪ <b>Total Revenue Loss of RD\$6.00 billion</b></li> </ul>	<ul style="list-style-type: none"> <li>▪ <b>Total Revenue Gain of 1.94% of GDP</b></li> <li>▪ <b>Total Revenue Gain of 1.71% of GDP</b></li> <li>▪ <b>Total Revenue Loss of 0.12% of GDP</b></li> <li>▪ <b>Total Revenue Loss of 1.53% of GDP</b></li> </ul>

Sources:

- 1 Section 3.1.
- 2 Table 4 in Section 3.1.
- 3 Table 5 in Section 3.1.
- 4 Section 3.1.
- 5 Section 3.2.
- 6 Section 4.
- 7 Section 5.
- 8 Section 6.3.
- 9 Section 6.3.
- 10 Section 5.
- 11 Section 5.
- 12 Section 6.4.
- 13 Sections 4 and 5.
- 14 Table 15 in Section 6.2.
- 15 Table 16 in Section 6.2.
- 16 Table 18 in Section 6.2.
- 17 Section 6.2.

## 7.4 Financing of Revenue Losses

With the proposed reforms package, the deficiency in revenues is expected to appear only after Phase III and Phase IV. The cumulative amount of additional revenue to finance this gap is 0.12 percent of GDP after Phase III, and 1.53 percent of GDP after Phase IV. One of the possible ways to bridge the difference is to increase the ITBIS rate so that the deficit is fully financed by additional collection from the ITBIS tax. Table 25 presents an estimation of the required ITBIS rate increase under two alternative scenarios: existing base of ITBIS and broadened base, as suggested in Section 4.

**Table 25**  
**Financing Phase III and Phase IV of Trade Tax Reform**

ITBIS System	ITBIS Collection at 12% (% of GDP)	ITBIS Effectiveness (% of GDP per ITBIS Rate Point)	Additional Revenue Requirement (% of GDP)	Estimated ITBIS Rate Increase (%)	Estimated ITBIS Rate (%)
<b>Financing of Phase III</b>					
Existing Base	4.215%	0.351	0.12%	0.34%	12.34%
Broadened Base	4.785%	0.399		0.30%	12.30%
<b>Financing of Phase IV</b>					
Existing Base	4.215%	0.351	1.53% (0.12% plus 1.40%)	4.36%	16.36%
Broadened Base	4.785%	0.399		3.83%	15.83%

The amount of ITBIS collection in terms of GDP share with a rate of 12 percent is currently 4.215 percent of GDP with the existing tax base, and this share is estimated to expand to 4.785 percent of GDP with a broadened base. The difference between the two figures is 0.57 percent of GDP estimated in Table 10 in Section 4. The effectiveness of both ITBIS systems, measured in terms of percentage of GDP per ITBIS rate point, is obtained by dividing the ITBIS collection by the statutory rate of 12 percent. Thus, a ITBIS system with the existing tax base collects 0.351 percent of GDP per ITBIS rate point, while a broadened base would result in a collection of 0.399 percent of GDP per ITBIS rate point. Even this estimated efficiency is low compared to other developing countries with similar GDP per capita.

Regardless of which ITBIS system is actually operated, Phase III tariff rates reduction will ask for an additional amount of RDS\$0.49 billion, or 0.12 percent of GDP, in order to stay revenue neutral. The estimated ITBIS rate increase is then obtained through dividing the effectiveness of ITBIS in terms of percentage of GDP per ITBIS rate point by the amount of additional revenue requirement. The resulting figures are very close to each other. If the existing ITBIS tax base is not broadened, the ITBIS rate increase should be 0.34 percent, implying a new 12.34 percent ITBIS rate. However, if the ITBIS tax base is broadened indeed, then the necessary rate raise is only 0.30 percent and the resulting ITBIS rate is 12.30 percent.

In order to finance the revenue gap after Phase IV, a higher ITBIS rate increase is needed. If the ITBIS system is not broadened then the estimated rate increase is 4.36 percent, resulting in a 16.36 percent ITBIS rate. But if the ITBIS tax base is broadened then the necessary rate increase is only 3.83 percent and the ITBIS rate is 15.83 percent. In practice, both estimates suggest that a 4.0 percent raise in ITBIS rate may be required to compensate for the loss of revenue after the final round of trade liberalization reforms.

The resulting 16 percent ITBIS rate is reasonable by regional and international standards. The net cumulative revenue impact of the proposed measures after Phase IV is a marginal loss of RD\$0.2 billion, or 0.005 percent of GDP.

## **8. Complying with WTO Restrictions on the Use of Free Trade Zones by 2008**

An important set of policy issues will be imposed on the Dominican Republic's operation of Free Trade or Export Processing Zones over the next five years due to its membership in the World Trade Organization.

At present, the free trade zones continue to play a very important role in the economy of the country. In 2002 there were 520 operating companies distributed across the country, providing employment for over 170,000 workers and generating a net revenue of exports over imports of approximately US\$1.7 billion a year. Textiles have made up over 50 percent of the exports and 70 percent of the employment of the zones, with the textile sales going mainly to the United States.

The role of the free trade zones in the Dominican Republic is somewhat different from their counterparts in most other countries. Rather than having their relative importance being reduced over time, we find that it is the zones that have expanded to incorporate a wide range of services that would be normally found outside of the zones in domestic economy. Their importance in terms of the volume of exports and employment has been growing since 1980 with only a slight decline since 2000. By 2002, exports from the free trade zones made up about 84 percent of all exports from the Dominican Republic.

Unlike some other countries, the free trade zones are not concentrated in one or two areas of the country. In total there are 53 parks that are spread over most of the areas of the country where there are concentrations of population. Hence, instead of bringing the workers to the free trade zones for employment, the free trade zones have been built close to where there is available labor. Another important feature is that over 50 percent of the zones are privately operated, and over a third of the companies operating in the zones are owned by citizens of the Dominican Republic. Rather than being a declining appendage to the modern industrial sector of a country as is the case for countries such as Malaysia, Singapore and Taiwan, in the Dominican Republic the free trade zones comprise almost all of the country's modern industrial sector.

In addition to the industrial site services provided by the zone operators, one of the principal

reasons why the free trade zones have developed in this way has been to insulate these activities from the historically weak and user unfriendly administration systems for taxation and customs. For companies operating in the zones, there are no taxes of any kind, except individual income taxes. Payments are made directly to the zone operators for the services received. Included in these payments is the cost of the services provided by the customs officers assigned to perform the customs functions associated with the zones.

The WTO in its efforts to reduce the inappropriate subsidization of exports has developed regulations governing the fiscal arrangements that are acceptable in the case of such free trade zones. The general rule is non-discrimination. In other words, the same tax policies that apply to the activities of companies producing and selling to the domestic market must also be applied to firms that are producing for export.

The three main taxation issues are:

1. The application of the same corporation income tax rules to firms producing and selling exports as for firms producing and selling into the domestic market.
2. The same tax treatment under the value added tax for firms producing exports in the free trade zones and for firms operating outside of the zones and producing for export.
3. The same customs treatment for the taxation of imports by firms operating the free trade zones and producing for exports as for firms operating in the domestic economy and producing for exports.

### **8.1 Extension of Corporation Income Tax to Firms in Free Trade Zones**

For a small open economy producing traded manufactured goods, the tax policies that have been given to companies operating in the zones are the correct ones. There are no subsidies, and at the same time there are no indirect domestic or trade taxes. Furthermore, there has been no corporation income tax on income earned in the free trade zones. For a country that is trying to raise the wages of its citizens by attracting foreign investment that will provide jobs this is also the appropriate tax policy.

In such a situation where the country has no control over the international cost of capital required to finance the investments in the zones and the prices of the services provided are fixed internationally, any additional corporation income taxes that levied on the income from capital investments in the zones will not change the net of tax return to companies but will force the wage rate being paid to labor they employ to be decreased. The reduction in the total wage bill paid to labor in the zones will be approximately equal to the additional corporation income taxes paid by these companies. As there is a competitive labor market wages will tend to be lower than otherwise across the economy. While labor in its role as a consumer of services will benefit from somewhat lower prices of services due to the fall in wages, it will only be a partial offset to the reduction in wages. Hence, the burden of the increase in corporation income taxes on the income from capital used to manufacture traded goods will

likely be borne more than 100 percent by labor.

There are some mitigating factors that will reduce the impact of the imposition of the corporation income tax on companies operating in the free trade zones. First, many of these companies are owned by US corporations. In these cases, some of the additional corporation income taxes may be used as a foreign tax credit against US tax due on the foreign source income. However, the value of these additional foreign tax credits should not be overstated as in many cases the US parent corporation may already have excess foreign tax credits. Also to the degree that the Dominican Republic corporations are subsidiaries of companies from countries that do not tax foreign source income of its multinationals, the additional foreign tax credits will be of no use to the parent companies. Second, given the multinational nature of the companies and the types of goods being sold, it will be relatively easy for these companies to transfer price the profits out of the Dominican Republic so that little or no corporation income tax may be paid by these companies.

A serious competitive problem may be created for these exporting companies if the 1.5 percent turnover tax is levied on the value of export sales for these companies as a prepayment of corporation income taxes. It might be acceptable to the WTO if the 1.5 percent withholding tax were not applied to export sales for all exporting companies whether operating inside or outside the zones. One of the main concerns of the multinational companies that now operate in the free trade zones, and who would become subject to the corporation income tax is the “hassle tax” that these enterprises may incur as they deal with the tax officials. In conclusion, it is not likely that the imposition of the corporation income tax on companies now operating in the free trade zones is in the best interest of the residents of the Dominican Republic. However, due to general applicability of this rule worldwide the Dominican Republic will likely be required to impose it in the near future.

## **8.2 Refunds of Excess ITBIS Input Taxes to Exporters**

There has been a longstanding operational policy not to refund taxes to taxpayers even when the taxpayer is legally entitled to such refunds. This has been one of the primary reasons why manufacturing exporters have concentrated their operations in the free trade zone areas. The fact is that the tax burden from not receiving the refunds of ITBIS paid on inputs would be much greater than is a payment of corporate income taxes. Most export activities are simply not internationally competitive if the indirect taxes paid on production inputs are not refunded in a timely fashion.

A number of ad-hoc provisions have been made to alleviate this problem for firms outside of the free trade zones. However, the fundamental policy toward the payment of refunds needs to be changed, and the appropriate administrative procedures to be implemented to bring it about.

One key provision that needs to be changed is the way in which the revenues and the refunds of the ITBIS are accounted for in the government budget. The collections of the tax are counted as revenues to the budget while the refunds are treated as expenditures. This is fundamentally incorrect. **The refunds should be deducted from the revenues received by the tax department and the net amount turned over to the Treasury. The refund system under the ITBIS is an integral part of the tax system, not an expenditure item that is subject to all the controls and constraints of regular government expenditures.**

In order to provide some comfort to the tax administration that fraud is not being engaged in by the taxpayers, it is recommended that they make an immediate refund of the excess tax credits only when the claim is certified by a reputable auditing firm that the claim is true and accurate. The auditing firm should in turn be responsible for any subsequent errors.

As the WTO continues to demand an equal treatment of exporting firms with firms producing for the domestic market there is a need for the Dominican Republic to implement modern tax administration procedures for the ITBIS as soon as possible. Further delay will simply mean higher compliance costs imposed on companies operating in the Dominican Republic, a loss of the exporter's competitive position, and lower wages for workers.

### **8.3 Exemption from Import Duties of Imported Inputs Used for Export Production**

The free trade zones in the Dominican Republic have enabled exporters to bypass the historically inefficient and ineffective Customs administration. Since the zones were first initiated a system has been in place whereby the zone operators pay Customs officials to supervise the inflow and outflow of goods for companies operating in the zones. It has generally worked well. However, it is a more costly system than others that have been developed elsewhere.

Most countries that have used export processing zones to initiate a drive toward export promotion have quickly moved to other systems for the exemption of these firms from the burden of import duties on inputs. These systems are usually information or accounting based. For a new exporter usually a bond is required to ensure that the inputs do not end up being used to produce goods that sold in the domestic market. However, after an honest track record is established the need for a customs bond is usually dropped. For example, in Taiwan the export processing zones were very important for its initial drive towards export promotion, but in no year did export shipments from the free trade zones exceed 9 percent of total exports from Taiwan. From the very beginning Taiwan realized that customs and tax administration reform was a cheaper way of promoting exports than having all their exporters working out of free trade zones.<sup>44</sup>

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<sup>44</sup> Jenkins, Glenn P., Chun-Yan Kuo and Keh-Nan Sun, *Taxation and Economic Development in Taiwan*, Cambridge: John F. Kennedy School of Government, Harvard University, 2003.

There is a need to have in place a system for refunding the duties paid on imported inputs through a system of duty drawbacks that will refund these duties on a timely basis. However, a duty drawback system will never be effective for servicing high volume exporters. Such a system is only useful for the case of a domestic producer who from time to time produces some items for export. Duty drawback systems are usually incubators for corruption, but there is a need to have such a system in place that will allow start up exporters to cease to be unduly burdened with such import duties.

In the Dominican Republic there has been a long tradition of a Customs Administration service that has been inefficient, and viewed as being difficult to reform. After some efforts to reform Customs in the 1990s it appears that it has deteriorated in recent years. The policy makers need to take a hard look at the situation and determine if the country can afford such a luxury. Countries from Bolivia to South Africa have decided that in order to develop they need to get rid of these inefficient administrative systems. To break away from these historical practices it often has been necessary to set up an autonomous revenue authority that has a clear mandate to introduce modern business practices into the administration of the tax and customs systems. The policy makers in the Dominican Republic need to examine such an alternative system of fiscal administration. We recommend that they implement such a system as soon as possible.

## **9. Issues of Tax and Customs Administration**

To be competitive in the contemporary world an efficient public administration is a necessary condition. Developing countries that have succeeded to break out of poverty have all dealt with the inefficiency that is epidemic in areas of public administrations. Tax and Customs administration, the system of the Justice and the regulation of financial institutions are the four most important components of public administration for the development of a competitive world-class economy. This report will focus on the state of tax and customs administration.

Over the past 10 years significant improvements have been made in the administration of taxes in the Dominican Republic. The level of professionalism of the staff has increased and the computerized information systems have been introduced and are being used. However, there are a number of current weaknesses in the tax administration that are hindering the government from implementing tax policies that will be badly needed by in the near future.

Some of the critical issues that need to be addressed include the following:

1. Need for a modern legal code for the administration of taxes.
2. Need to develop credibility with the taxpayers and create a corruption free, service-oriented, and efficient tax and customs administration.
3. Need to issue refunds quickly to exporters operating outside of the free trade zones for excess ITBIS input tax credits.

4. Need to develop and implement a system for duty exemption for imported goods to be used by exporters operating outside the free zones.
5. Need to strengthen the audit capabilities of both the tax administration and customs.
6. Need to recruit professional staff and reduce the unnecessary staff employed by the Customs and tax administrations.
7. Need to upgrade the information systems used by the Customs Department and to improve the capability of the Customs department in the valuation of imported goods.

### **9.1 Legal Code for the Administration of Taxes**

The procedures and organization currently embodied in the legal framework of the tax code for the administration of the tax system is no longer suitable as the legal foundation for a modern tax administration. There is an urgent need to have a thorough review of the current tax code in order to make it consistent with modern practices of tax administration.

Every effort must be made to build credibility with the public by emphasizing efficiency, and fairness, while at the same time having the capacity for enforcing compliance.

The upgrading of the legal basis for tax administration should be carried out at the same time as there is a rethinking of the overall organization of how taxes and customs will be administered in the future.

### **9.2 Implementation of a Semi-Autonomous Revenue Authority**

Although a number of improvements have been made in the administration of both taxes and customs. However, the present situation is far from what is needed. Because of the Dominican Republic' dependence on international trade and international investment it is critical that the public administration in the fiscal areas be of world class. Although a great deal of effort has been made by the international donor community over the past 15 years to improve the situation, the progress has been fairly slow.

This is a situation that virtually all the tax and customs administrations in developing countries found themselves in during the early 1980s.<sup>45</sup> Since then a number of governments, led by Singapore, and Taiwan, have undertaken radical administrative reforms in the area of taxation and customs to allow the private sector to compete effectively in international markets. For the Dominican Republic the administration innovation that enabled the economy to compete internationally was the development of the free trade zones, and the development of the

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<sup>45</sup> A notable exception to this statement would be Chile.

infrastructure that created a highly efficient tourist services sector. However, the era is passed for fostering development through free trade zones. They are not efficient enough, nor will they be internationally accepted in the near future.

Many countries have not been able to bring about the necessary administrative modernization of tax and customs systems through the normal government departmental organizations. Over 20 developing and developed countries have set up semi-autonomous revenue authorities to bring about the administrative reforms needed for the modern administration of taxation and customs. In many cases it has been a very effective avenue to bring about needed organizational and operational changes as well as for building political credibility with taxpayers and investors.

**It is our recommendation that the Dominican Republic should combine the Customs and Tax Administrations and form a semi-autonomous revenue authority. Given the need for a rapid improvement in the quality of service in these areas, it is likely that such a reform would only be possible if it were undertaken by such an institution.**

There are many designs of these semi-autonomous revenue authorities (ARA), and every country will have different political and legal requirements. A key characteristic for success to give the organization a significant degree of true autonomy. Recent research on the experience of semi-autonomous revenue authorities around the world has pointed out a few characteristics that seem to be important for success.<sup>46</sup>

They are as follows:

### **Legal Foundation**

1. To bolster autonomy the ARA should have a separate corporate character as defined by national law.
2. To strengthen autonomy the ARA should have the right to own assets.
3. To make the autonomy effective the ARA should be exempt from specific government-wide regulations, including civil service regulations and in many cases also government-wide procurement regulations.
4. To safeguard autonomy the ARA's legal foundation should be based on legislative, not executive, authority.

### **Corporate Governance**

5. To strengthen autonomy the chairperson of the board of directors should be appointed by the president, approved by the legislature, and subject to a fixed term of service.

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<sup>46</sup> Robert Taliencio, Jr., "Designing Performance: The Semi-Autonomous Revenue Authority Model in Africa and Latin America", paper prepared for the World Bank, November 2003.

6. Public sector representatives on the Board of Directors should serve in an *ex officio* (i.e., non-voting) capacity to increase revenue authority autonomy.
7. Private sector representatives from reputable professional associations and business groups, whose positions are fixed in the legislation, can bolster ARA autonomy by insulating it from negative political interference.
8. To protect autonomy board members should be appointed for fixed terms. To enhance accountability board members should be nominated by the Ministry of Finance and appointed by the legislature.
9. For greater autonomy and accountability, the board of directors model is preferred to the superintendent model.

### **Funding**

10. A fixed percentage-based funding mechanism, coupled with other design features, can provide greater operational autonomy, and, if properly linked to a staff performance bonus system, can enhance incentives for increasing collections.
11. Direct retention of funds by ARAs to cover the agreed fee for service can help mitigate the negative impacts of operating in a dysfunctional public expenditure management system.

### **Budget Management**

12. Revenue authority autonomy is strengthened by control over budget formulation, subject to approval either by the board of directors or an appropriate oversight agency.

### **Personnel Management**

13. To safeguard autonomy the ARA personnel system should be: (a) exempted in the ARA founding law from government-wide civil service regulations, and (b) the personnel compensation scheme should be developed and regulated exclusively by the board of directors.

### **Procurement Management**

14. Empowering ARAs to design their own procurement systems, under the supervision of boards of directors and other relevant oversight agencies, makes autonomy more meaningful at the operational level.

### **Accountability**

15. To ensure fiduciary and democratic accountability, formal, regularized linkages between the ARA and the legislature should be established.

16. Taking accountability seriously means crafting a set of accountability linkages between the ARA and responsible oversight bodies, including the board of directors, the ministry of finance, the comptroller/auditor general, and parliament.

Given the history of the tax and customs administrations in the Dominican Republic it would appear that combining the administration of customs and the tax administrations into a single semi-autonomous revenue authority is needed in order to get the quality of services that the country needs. While the Dominican Republic will have to work out its own design to fit its particular needs, the guidelines outlined above that are derived from the experience of others are likely to serve as useful reference point for bringing about an institutional change.

## **10. Conclusion**

The financial crisis of 2003 and the approaching date of trade liberalization with the Americas have sharpened the need for a major overhaul of the existing tax system and policies in the Dominican Republic. The desired properties of a reformed system are revenue sufficiency, buoyancy, fairness, administrative simplicity and an orientation for the promotion of sustainable economic growth.

We believe these objectives are possible to achieve over a fairly short period. We have examined many aspects of the tax policy as well as the tax administration in order to develop a comprehensive set of reform proposals. The final result of this reform should be an economy open to international trade with a balanced tax system that would rely more heavily than today on the value added tax and selective excise taxes.

A central feature of this reform is the recommendation for the modernization of the tax and customs administration. A determined prudent effort is needed to revive and modernize their functions in order to attain the level of efficiency that the Dominican Republic needs in order to have an internationally competitive economy.

**Appendix A**  
**Number of Firms and Gross Sales by Sector, 2000-2002**  
**(thousands of RD pesos)**

<b>Sector</b>	<b>#Firms</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>
Agriculture	2	25,293	83,158	83,412
Cereals	1	257,333	287,345	296,582
Chemical Products	63	16,970,348	18,178,276	20,413,240
Commerce	148	46,934,165	43,763,364	49,732,738
Communication	13	3,800,725	5,272,992	6,482,393
Construction	22	306,943	1,392,400	2,079,460
Education	4	38,692	65,384	136,305
Financial Services and Insurance	68	3,454,953	9,344,940	12,870,759
Food Processing	41	16,653,159	17,014,922	17,919,128
Health	8	144,155	202,727	270,130
Hotels and Restaurants	71	6,166,918	8,027,413	9,729,084
Machinery and Electrical Appliances	3	85,946	128,559	116,312
Manufacturing	43	5,398,171	5,588,434	6,059,065
Metal Products	6	2,997,445	2,492,092	2,613,574
Milling	4	667,377	682,799	1,294,004
Mining	1	0	75,085	36,849
Miscellaneous Non-Metal Products of Mineral Origin	3	118,415	108,656	121,283
Miscellaneous Services (Medical, Casino, etc.)	17	431,099	392,734	346,046
Non-Metal Products of Mineral Origin	18	2,754,800	2,376,421	2,701,469
Oil Refinery	13	33,092,662	43,500,162	31,894,190
Petroleum Products	5	71,905	222,992	248,097
Plastics	3	150,853	217,819	262,351
Production of Sugar	2	2,540,536	2,829,145	3,163,505
Production of Tobacco and Beverage	26	16,809,117	17,049,030	19,327,552
Products of Rubber and Plastics	15	1,873,039	2,203,030	2,497,930
Services to Enterprises	17	497,296	2,229,467	2,783,251
Textile and Accessories	7	495,321	486,927	586,421
Transportation	43	24,854	4,844,115	6,007,339
Water and Electricity	13	0	4,485,919	6,011,595
<b>Total</b>	<b>680</b>	<b>162,761,518</b>	<b>193,546,308</b>	<b>206,084,061</b>
<b>Total ITBIS Registrants</b>		<b>300,706,632</b>	<b>366,082,845</b>	<b>390,575,399</b>

**Appendix B1**  
**Average Effective Tax Rates of Vehicles by Regime, 2002**  
**-- Inclusive of All Resolutions --**

<b>Regime</b>	<b>Import at CIF Value (RD\$000)</b>	<b>Import Duty (RD\$000)</b>	<b>Excise Tax (RD\$000)</b>	<b>Effective Excise Tax Rate (%)</b>
1	10,396,217	1,825,184	213,834	1.75
2	1,419	208	0	0
3	20,000	3,637	1,522	6.44
4	7,569	1,192	491	5.60
6	188,694	37,722	7,763	3.43
9	283	57	0	0
10	4,725	945	0	0
11	86,391	17,107	213	0.20
14	1,462	292	205	11.69
<b>Total</b>	<b>10,706,762</b>	<b>1,886,345</b>	<b>224,027</b>	<b>1.78</b>

**Appendix B2**  
**Average Effective Tax Rates of Vehicles by Resolutions in Regime 1, 2002**

<b>Resolution</b>	<b>Import at CIF Value (RD\$000)</b>	<b>Import Duty (RD\$000)</b>	<b>Excise Tax (RD\$000)</b>	<b>Effective Excise Tax Rate (%)</b>
1	68,554	3,114	282	0.39
2	20,481	110	0	0
4	3,827	130	18	0.45
6	2,168	0	0	0
7	15,910	419	20	0.12
10	54,854	17	0	0
11	644,397	190	7	0
12	313,068	7,100	1,843	0.58
13	8,068	139	0	0
16	44,328	506	36	0.08
17	183,710	7,040	997	0.52
19	775	88	26	3.01
<b>Total</b>	<b>1,360,139</b>	<b>18,853</b>	<b>3,229</b>	<b>0.23</b>

**Appendix C**  
**Import Quota and Import Duty Rates**

Commodity	Year	Import Quota (MT)	Import Duty Rates (%)	
			Normal Rate	Rate if Imports go over Quota
Garlic	2003	4,200	20	101
	2004	4,350	20	99
Rice	2003	16,988	20	104
	2004	17,399	20	99
Sugar	2003	29,000	20	86
	2004	30,000	20	85
Poultry	2003	10,500	25	111
	2004	11,500	25	99
Onion	2003	3,500	20	97
	2004	3,625	20	97
Beans	2003	16,800	25	91
	2004	17,400	25	89
Powdered Milk	2003	32,000	20	65
	2004	32,000	20	56
Corn	2003	1,013,400	0	46
	2004	1,052,200	0	40

**Appendix D**  
**Comparison of Tax Burdens between Current and Proposed Excise Tax Systems**  
**on Imported Goods by Regime after Phase I of Reform, 2002**

<b>Regime</b>	<b>Commission on Foreign Exchange (RD\$000)</b>	<b>Import Duty (RD\$000)</b>	<b>Excise Tax (RD\$000)</b>	<b>ITBIS (RD\$000)</b>	<b>Total</b>
<b>The Current System by Modeling</b>					
1	494,043	2,075,147	231,862	1,524,726	4,325,778
2	67	84	37	209	397
3	950	4,000	438	2,933	8,321
4	360	1,514	243	1,119	3,236
6	8,963	37,739	4,430	27,703	78,835
9	13	57	6	42	118
10	224	945	104	693	1,966
11	4,104	17,278	1,860	12,664	35,906
14	69	292	122	225	708
<b>Total</b>	<b>508,793</b>	<b>2,137,056</b>	<b>239,102</b>	<b>1,570,314</b>	<b>4,455,265</b>
<b>The Proposed System</b>					
1	0	1,039,622	2,287,168	1,646,596	4,973,386
2	0	142	312	225	679
3	0	2,000	4,400	3,168	9,568
4	0	757	1,665	1,199	3,621
6	0	18,869	41,513	29,889	90,271
9	0	28	62	45	135
10	0	472	1,039	748	2,259
11	0	8,639	19,006	13,684	41,329
14	0	146	322	232	700
<b>Total</b>	<b>0</b>	<b>1,070,675</b>	<b>2,355,487</b>	<b>1,695,786</b>	<b>5,121,948</b>

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